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Nos. 265 and 268

In the Supreme Court of the United States

OCTOBER TERM, 1941

FEDERAL POWER COMMISSION AND ILLINOIS COMMERCE COMMISSION, PETITIONERS

v.

NATURAL GAS PIPELINE COMPANY OF AMERICA, AND TEXOMA NATURAL GAS COMPANY

NATURAL GAS PIPELINE COMPANY OF AMERICA AND TEXOMA NATURAL GAS COMPANY, PETITIONERS

v.

FEDERAL POWER COMMISSION AND ILLINOIS COMMERCE COMMISSION

ON WRITS OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SEVENTH CIRCUIT

BRIEF FOR THE FEDERAL POWER COMMISSION AND ILLINOIS COMMERCE COMMISSION

INDEX

	Page
Opinions below	1
Jurisdiction	2
Questions presented	2
Statute involved	3
Statement	3
A. Proceedings before the Commission	4
B. Business of the companies	6
C. Financial history of the companies	8
D. Opinion and order of the Commission	11
E. Action of the court below	15
F. Contentions of the parties	16
Specification of errors to be urged in No. 265	17
Summary of argument	18
Argument:	
I. The Natural Gas Act of 1938 is a valid regulation of interstate commerce	24
II. The Natural Gas Act authorized the Commission, after granting a full hearing to the companies, to enter an interim order directing the companies to file a new schedule of rates reflecting a prescribed reduction in operating revenues	26
A. The Commission acted properly in entering an interim order on the companies' evidence	27
B. The Commission acted properly in directing the companies to file a new schedule of rates reflecting a prescribed reduction in operating revenues	30
III. The issues before this Court on the merits	32
IV. The reduction in rates ordered by the Commission does not violate the companies' constitutional rights	37
A. The Commission properly refused to make a separate allowance for going concern value	39
1. The facts with respect to the companies' claim for a separate allowance for going concern value	39
2. The controlling decisions of this Court support the Commission's denial of the companies' claim	45

433856—41——1

Argument—Continued. Page

3. On principle, the inclusion in the rate base of an allowance for going concern value is not required by the Constitution under any permissible theory of rate regulation 54

B. The Commission made a proper allowance for amortization 68

1. The Commission properly provided for amortization of only the investment in the property 70

2. The Commission properly fixed the amortization period as the entire life of the enterprise 79

3. The Commission used a proper rate of interest in computing the amortization allowance 95

C. The Commission provided a proper rate of return 101

V. The Commission's findings that the companies' existing rates are unreasonable and that the level of rates fixed by the Commission are reasonable are supported by substantial evidence 106

VI. *Smyth* v. *Ames* is not based on sound principles and should be overruled 112

A. The fair value rule is based on eminent domain concepts 113

B. The eminent domain concept of present fair value has no place in rate regulation 116

C. Rate regulation should be deemed violative of due process only if arbitrary or unreasonable 122

D. It is not unreasonable to limit the earnings of a utility to a fair return upon the capital prudently invested 127

Conclusion 133

Appendix A 134

Appendix B 139

CITATIONS

Cases:

Alabama Water Service Co. (Ala. 1940), 32 P. U. R. (N. S.) 129 79

Alexandria Water Company v. *City Council of Alexandria*, 163 Va. 512 78

Alexandria Water Co. v. *City Council of Alexandria* (Va. 1935), 7 P. U. R. (N. S.), 53 78

Ames v. *Union Pacific Ry.*, 64 Fed. 165 115

Ranton v *Belt Line Ry.*, 268 U. S. 413 110

Cases—Continued. Page

Block v. *Hirsch*, 256 U. S. 135 123
Bluefield Co. v. *Public Service Comm.*, 262 U. S. 679 101
Board of Public Utility Commissioners v. *New York Tel. Co.*, 271 U. S. 23 ..... 67, 84
Bothwell v. *United States*, 254 U. S. 231 117
Bronx Gas & Electric Co., Matter of v. *Maltbie*, 271 N. Y. 364 29
Budd v. *New York*, 143 U. S. 517 114
C. C. C. & St. L. Ry. v. *Backus*, 154 U. S. 439 117
8 L. R. App. Cas. 723 110
Canada Southern R. Co. v. *International Bridge Co.*, [1883], ...
Cedar Rapids Gas Light Co. v. *Cedar Rapids*, 223 U. S. 655 ..... 55, 61
Central Light & Power Co., Re, (N. D. 1941), 37 P. U. R. (N. S.) 106 79
Chicago Ry. v. *Minn.*, 134 U. S. 418 114
City of Fort Smith v. *Southwestern Bell Telephone Co.*, 270 U. S. 627, affirming without opinion *Southwestern Bell Telephone Co.* v. *City of Fort Smith*, 294 Fed. 102 .. 52, 53
City of Los Angeles v. *Nevada-California Electric Corp.* (Fed. Power Comm. 1940), 32 P. U. R. (N. S.) 193 .. 79
Clark's Ferry Co. v. *Public Service Commission*, 291 U. S. 227 ..... 59, 83, 91, 120
Columbus Gas & Fuel Co. v. *Public Utilities Commission*, 292 U. S. 398 ..... 46, 49, 51, 52, 55, 110
Cotting v. *Kansas City Stock Yards Co.*, 183 U. S. 79 ... 110
Covington & Lexington Turnpike Road Co. v. *Sandford*, 164 U. S. 578 115
Creeley v. *Creeley*, 258 Mass. 460 126
Dayton P. & L. Co. v. *Public Utilities Commission*, 292 U. S. 290 ..... 46, 49, 52, 55
Denver v. *Denver Union Water Co.*, 246 U. S. 178 54
Denver Stock Yard Co. v. *United States*, 304 U. S. 470 ... 46, 55, 59, 110
Des Moines Gas Co. v. *Des Moines*, 238 U. S. 153 .... 46, 55, 59, 67
Driscoll v. *Edison Co.*, 307 U. S. 104 ..... 29, 30, 31, 46, 56, 112, 132
Electric Bond & Share Company v. *Securities & Exchange Commission*, 303 U. S. 419 25
Euclid v. *Ambler Co.*, 272 U. S. 365 125
Galveston Elec. Co. v. *Galveston*, 258 U. S. 388 ..... 20, 49, 50, 51, 53, 55, 65
Georgia Railroad & Banking Co. v. *Smith*, 128 U. S. 174 .. 114
Georgia Railway & Power Co. v. *Railroad Commission*, 262 U. S. 625 ..... 61, 83
Hadacheck v. *Los Angeles*, 239 U. S. 394 124
Hudson Water Co. v. *McCarter*, 209 U. S. 349 124
Houston v. *Southwestern Bell Telephone Co.*, 259 U. S. 318 .. 55

Cases—Continued. Page

Illinois Central Railroad v. *Interstate Commerce Commission*, 206 U. S. 441 82
Interstate Commerce Commission v. *Oregon-Washington R. Co.*, 288 U. S. 14 ..... 126, 127
Joslin Co. v. *Providence*, 262 U. S. 668 117
Kings County Lighting Company v. *Willcox*, 210 N. Y. 479 66
Knoxville v. *Knoxville Water Co.*, 212 U. S. 1 ..... 78, 84, 92, 94
Lawton v. *Steele*, 152 U. S. 133 124
Lincoln Gas & Elec. Co. v. *Lincoln*, 250 U. S. 256 ..... 67, 102
Lincoln Tel. & Tel. Co. (Neb. 1935), 6 P. U. R. (N. S.) 81 78
Lindheimer v. *Illinois Bell Tel. Co.*, 292 U. S. 151 ..... 77, 81, 82, 84, 85, 94
Los Angeles Gas Co. v. *Railroad Commission*, 289 U. S. 287 ..... 34, 46, 47, 49, 51, 55, 58, 61, 71, 110, 111, 118
Long Branch Sewer Co. (N. J.), P. U. R. 1931A, 467 78
McCardle v. *Indianapolis Water Co.*, 272 U. S. 400 ..... 46, 54, 55, 59, 61, 84
Miller v. *Schoene*, 276 U. S. 272 125
Minnesota Rate cases, 230 U. S. 352 ..... 59, 84, 127
Missouri v. *Kansas Gas Co.*, 265 U. S. 298 24
Mitchell v. *United States*, 267 U. S. 341 117
Mock Co. v. *Rensselaer Water Co.*, 247 N. Y. 160 126
Mondovi Tel. Co. (Wis.) P. U. R. 1933B, 319 78
Mondovi Tel. Co. (Wis.), P. U. R. 1933D, 142 78
Monongahela Bridge Co. v. *United States*, 216 U. S. 177 125
Monongahela Navigation Co. v. *United States*, 148 U. S. 312 ..... 117, 120
Mugler v. *Kansas*, 123 U. S. 623 124
Munn v. *Illinois*, 94 U. S. 113 ..... 57, 114, 117
Natural Gas Pipeline Co. v. *Slattery*, 302 U. S. 300 91
Nebbia v. *New York*, 291 U. S. 502 ..... 25, 125, 127
New England Divisions Case, 261 U. S. 184 ..... 28, 31
Newton v. *Consolidated Gas Co.*, 258 U. S. 165 ..... 53, 55, 67
New York & Queens Gas Co. v. *McCall*, 245 U. S. 345 126
New York ex rel. Woodhaven Gas Light Co. v. *Public Service Commission*, 269 U. S. 244 126
New York Telephone v. *Prendergast*, 36 F. (2d) 54 89
North Dakota Power & Light Co. (N. D. 1940), 31 P. U. R. (N. S.) 26 79
Northern Power & Light Co. (N. D. 1939), 30 P. U. R. (N. S.) 1 79
Northern States Power Co. (N. D. 1938) 22 P. U. R. (N. S.) 364 78
Northwestern Laundry v. *Des Moines*, 239 U. S. 486 124
North West Tel. Co. (Wis.), P. U. R. 1931A, 53 78
Olsen v. *Nebraska*, 313 U. S. 236 24
Otter Tail Power Co. (N. D. 1940), 33 P. U. R. (N. S.) 301 79

Cases—Continued. Page

Pacific Tel. & Tel. Co. v. *Wallace* (Ore. 1938), 23 P. U. R. (N. S.) 65 78
Patrons of Lakeville Water Co. (Conn.), P. U. R. 1932D, 138 78
Pennsylvania Coal Co. v. *Mahon*, 260 U. S. 393 125
Peoples Gas Co. v. *Public Service Commission*, 270 U. S. 550 24
Peoples Gas Light & Coke Co. (Ill. 1937), 19 P. U. R. (N. S.) 177 78
Peoples Gas Light & Coke Co. v. *Slattery*, 373 Ill. 31 83
Powell v. *Penna.*, 127 U. S. 678 124
Public Utility Commission v. *Attleboro Co.*, 273 U. S. 83 24
Railroad Commission v. *Pacific Gas Co.*, 302 U. S. 388 ..... 71, 110
Railroad Commission Cases, 116 U. S. 307 114
Reagan v. *Farmer's Loan & Trust Co.*, 154 U. S. 362 114
Reinman v. *Little Rock*, 237 U. S. 171 124
Ribnik v. *McBride*, 277 U. S. 350 57
St. Louis & O'Fallon Ry. Co. v. *United States*, 279 U. S. 461 111
Siegel v. *Spear & Co.*, 234 N. Y. 479 126
Slater v. *Illinois Central R. Co.*, 209 Fed. 480 126
Smyth v. *Ames*, 169 U. S. 466 ..... 20, 23, 35, 36, 70, 71, 74, 76, 79, 83, 109, 112, 115, 116, 117, 128, 131, 132
Southwestern Bell Tel. Co. v. *Public Service Commission*, 262 U. S. 276 ..... 35, 118, 120, 128, 132
Standard Oil Co. v. *Marysville*, 279 U. S. 582 124
State Commission v. *Wichita Gas Co.*, 290 U. S. 561 24
Sunshine Anthracite Coal Co., v. *Adkins*, 310 U. S. 381 24
Swan Creek Electric Co. (Utah 1940), 35 P. U. R. (N. S.) 315 79
Telephone and Railroad Depreciation Charges, 177 I. C. C. 351 ..... 78, 80, 84
Union Bridge Co. v. *United States*, 204 U. S. 364 125
United Fuel Gas Co. v. *Kentucky Railroad Comm.*, 13 F. (2d) 510, aff'd. 278 U. S. 300 93
United Fuel Gas Co. v. *W. Va. Pub. Serv. Comm.*, 14 F. (2d) 209, aff'd 278 U. S. 322 93
United Gas Co. v. *Railroad Commission*, 278 U. S. 300 ..... 26, 126
United Railways v. *West*, 280 U. S. 234 ..... 54, 71, 72, 76, 77, 90, 94
United States v. *Darby*, 312 U. S. 100 24
United States v. *Ludey*, 274 U. S. 295 77
United States v. *New River Collieries Co.*, 262 U. S. 341 122
United States v. *Rock Royal Cooperative*, 307 U. S. 533 24
Wabash Valley Electric Co. v. *Young*, 287 U. S. 488 104
West v. *Chesapeake & Potomac Tel. Co.*, 295 U. S. 662 ..... 71, 109, 113, 116, 118, 120
West Chicago Street Railway v. *Chicago*, 201 U. S. 506 125
Willcox v. *Consolidated Gas Co.*, 212 U. S. 19 ..... 61, 102
Wisconsin Tel. Co. (Wis. 1936), 13 P. U. R. (N. S.) 224 78

Cases—Continued. Page
Wolff v. *Court of Industrial Relations*, 262 U. S. 522 26
Yonkers Railroad Co. (N. Y.), P. U. R. 1933B, 61 78
Yonkers Railroad Co. (N. Y. 1935), 9 P. U. R. (N. S.) 337 78
U. S. Constitution and Statutes:
United States Constitution, Fifth Amendment 24
Natural Gas Act of 1938, c. 556, 52 Stat. 821, 15 U. S. C. Supp. V, §§ 717–717w:
Sec. 1. (a) 134
Sec. 4 31
Sec. 4. (a) 3, 134
Sec. 5 ..... 18, 31
Sec. 5. (a) 4, 17, 27, 28, 33, 110, 134
Sec. 6 109
Sec. 6. (a) 107, 135
Sec. 6. (b) 108, 135
Sec. 7 25
Sec. 9. (a) 136
Sec. 13 ..... 4, 136
Sec. 16 ..... 18, 29, 31
Sec. 19. (a) 136
Sec. 19. (b) 15, 32, 137
Sec. 23 25
Miscellaneous:
Bauer and Gold, *Public Utility Valuation* 47, 57, 58, 118, 121
Bell and Jones, *Auditing* (1941) 245 73
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Miscellaneous—Continued. Page

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11 Minn. L. Rev. 642, 650n (decisions of Wisconsin Public Service Commission) 66
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S. 2796, 74th Cong., 1st sess. 108
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Uniform System of Accounts for Natural Gas Companies, promulgated by the Federal Power Commission, effective January 1, 1937 80
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OPINIONS BELOW

The opinion of the Circuit Court of Appeals (R. 4026–4041) is reported in 120 F. (2d) 625. The memorandum opinion of the Federal Power Commission appears at R. 3925–3942.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered on April 14, 1941 (R. 4041). The petition and cross-petition were filed on July 12 and July 14, 1941, respectively, and were granted on October 13, 1941. The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTIONS PRESENTED

1. Whether the Natural Gas Act of 1938 is a valid regulation of interstate commerce as applied to the companies here involved.

2. Whether the Commission is authorized under the Act to enter an interim order after hearing all of the companies' evidence.

3. Whether the Commission is authorized under the Act to enter an order directing the companies to file a new schedule of rates reflecting a prescribed reduction in operating revenues.

4. Whether the Commission's refusal to make a separate allowance for going concern value in fixing the rate base makes its order either confiscatory or unreasonable.

5. Whether the allowance made by the Commission for amortization makes its order either confiscatory or unreasonable, either because (a) the Commission provided for amortization of only the investment in the property, (b) it fixed the amortization period as the entire life of the enter-

prise, or (c) it used a 6½% compound interest rate to compute the allowance.

6. Whether the 6½% rate of return allowed by the Commission makes the order either confiscatory or unreasonable.

7. Whether, in determining the validity of the Commission's rate order, the Constitution is to be interpreted as requiring a fair return on the present fair value of the companies' properties or only as requiring a fair return on the companies' investment in the properties.

STATUTE INVOLVED

The pertinent provisions of the Natural Gas Act of 1938, c. 556, 52 Stat. 821, 15 U. S. C., Supp. V, §§ 717–717w, are set forth in Appendix A, *infra*, pp. 134–138.

STATEMENT

The Natural Gas Act of 1938 declares that the "business of transporting and selling natural gas for ultimate distribution to the public is affected with a public interest," and that federal regulation of interstate commerce in natural gas "is necessary in the public interest" (Sec. 1 (a)). The Act requires *inter alia* that all rates and charges in connection with the transportation or sale of natural gas subject to the jurisdiction of the Commission shall be "just and reasonable," and declares any rate or charge that is not just and reasonable to be unlawful (Sec. 4 (a)). The

Federal Power Commission, on its own motion, or on complaint of a state, municipality, state commission, or gas distributing company, is empowered to investigate the rates charged by any natural gas company in connection with any transportation or sale of natural gas, subject to the jurisdiction of the Commission, and to determine just and reasonable rates, and "may order a decrease where existing rates are unjust, unduly discriminatory, preferential, otherwise unlawful, or are not the lowest reasonable rates" (Sec. 5 (a)).

A. PROCEEDINGS BEFORE THE COMMISSION

On September 23, 1938, shortly after the effective date of the Natural Gas Act,[1] the Illinois Commerce Commission, pursuant to Sections 5 (a) and 13 of the Act, filed with the Federal Power Commission a complaint charging the Natural Gas Pipeline Company of America and the Texoma Natural Gas Company (hereinafter referred to as "the companies") with exacting unjust and unreasonable rates and praying for an order "setting fair, reasonable, and just rates" (R. 1–6). On October 14, 1938, the Federal Power Commission, on its own motion, instituted an investigation of the companies' rates (R. 6–9). After answer denying most of the material allegations of the complaint (R. 9–12), the two proceedings were consolidated for hearing (R. 13–14).

[1] The Act was approved June 21, 1938, 52 Stat. 833.

Hearings were begun on May 8, 1939, and continued intermittently for over five months, sessions being held on some 56 days (R. 3994–3995). After preliminary testimony concerning the companies' gas reserves and their sales and rates by the Principal Gas Engineer of the Federal Power Commission (R. 35), and the presentation of earnings and expense data by an accountant employed by the Illinois Commerce Commission (R. 57), the companies complied with the direction of the Power Commission's examiner that they present their evidence first (R. 64). The companies presented 37 witnesses (R. 187–1976) who testified fully on their behalf. On October 6, 1939, the companies announced to the examiner that they had concluded their direct testimony in support of their case (R. 4004). Thereafter, seven of their witnesses were cross-examined, reexamined, and recross-examined, and counsel for the two commissions presented four witnesses who testified largely on the subject of rate of return (R. 4004). On November 7, 1939, counsel for the two commissions joined in filing a motion on the basis of the evidence then of record, for an immediate interim order reducing the companies' alleged excessive and unlawful rates and charges (R. 2098–2100, 3903–3914). Thereafter, additional hearings were held at which the companies cross-examined the witnesses produced by the two commissions and later presented evidence on redirect

and in rebuttal, also mainly on the rate of return (R. 4004–4005, 3929). Oral argument on the motion was had before the full Commission on December 18, 1939 (R. 2557, 3927), and the companies filed pleas to the jurisdiction of the Commission to enter the requested order (R. 3914–3919) as well as an answer on the merits (R. 3920–3924), and a brief on the jurisdictional issue (R. 3927, 4006). Thereafter, at the request of the companies, additional hearings were held to afford them further opportunity to present additional rebuttal testimony dealing with the issue of a proper rate of return and also to afford them opportunity to cross-examine one of the Commission witnesses who had previously given redirect testimony (R. 3927). The companies' brief on the merits was filed on February 15, 1940 (R. 3927). On July 23, 1940, the Commission issued a memorandum opinion (R. 3925–3942) and an interim order reducing rates (R. 3942–3946). That interim order is the order now under review. Its precise nature is discussed below (*infra*, pp. 11–15). A petition for rehearing filed by the companies (R. 3961–3993) was denied by the Commission (R. 3993–3994).

B. BUSINESS OF THE COMPANIES

The companies are Delaware corporations and their principal place of business is in Chicago, Illinois (R. 1). Conducted as a single enterprise (R. 11, 3944), they are engaged in produc-

ing and purchasing natural gas, transporting it in interstate commerce, and then selling it at wholesale (R. 11). Three-fourths of their market requirements are produced from their own reserves in the Panhandle gas field of Texas and one-fourth, produced in the same field, is purchased from the Colorado-Interstate Gas Company (R. 576). The companies transport their gas through their own pipeline which extends from Texas to Illinois (R. 37, 38).

About 98% of the gas transported through the pipeline is sold at wholesale to utilities which in turn resell the gas to the public for domestic, commercial, and industrial uses. The remaining 2% is sold directly to industrial users along the line (R. 2683). About 90% of the gas is sold, under contract, to an affiliated pipeline company, the Chicago District Pipeline Company, which in turn sells to affiliated utility companies (R. 2683, 2691). This contract, entered into on September 25, 1931, is to run for fifteen years and is renewable for a period of five years at the option of the Natural Gas Pipeline Company of America. The Chicago District Pipeline Company resells the gas which it purchases from the companies to the Peoples Gas Light and Coke Company, Public Service Company of Northern Illinois and Western United Gas & Electric Company. These public utilities distribute the natural gas, in most cases with a mixture of artificial gas, in the Chicago metro-

politan area and northern Illinois (R. 3). They have guaranteed the contract of the Chicago District Pipeline Company with the Natural Gas Pipeline Company of America (R. 3). Several smaller distributing utilities also purchase gas from the companies for resale (R. 2683).

The construction of the companies' pipe line was commenced in 1930 and completed near the end of 1931 (R. 518, 560) and operating records were set up as of January 1, 1932 (R. 561).

Witnesses for the companies testified that the economic life of their natural gas reserves would be 23 years—1932 to 1954, inclusive—and that at the end of that period the companies would be forced to discontinue business because of exhaustion of the supply (R. 1400). For purposes of the interim order here under review, the Commission assumed that the companies' business would continue only until December 31, 1954 (R. 3938).[2]

C. FINANCIAL HISTORY OF THE COMPANIES

At the beginning of operations, the companies' capital structure consisted of $60,000,000 of 6% bonds and $3,500,000 of common stock. Of this $3,500,000 of common stock, $500,000 represents stock issued by Texoma, which is a non-profit corporation and which consequently pays no divi-

[2] There was evidence in the record, however, that the life of the companies would be considerably longer (R. 54, 3374, 3401, 3408).

dends on its stock (R. 3712). By December 31, 1933 the bond figure was increased to $60,999,000 (R. 2991). All of the bonds are held by six large corporations,[3] which also hold all of the stock of the companies; the bonds held by each of the six stockholder corporations are in proportion to the stock held by each (R. 3781).

During the first seven years of operations ending on December 31, 1938, the companies built up a reserve for depreciation and depletion amounting to $12,557,892, and in addition charged $6,481,322 as operating expenses for retirements beyond the amount charged against the depreciation and depletion reserves (R. 2959). The sum thus made available was used in part to retire $14,499,000 of the bonds (R 2991). The companies also declared dividends of $9,150,000 during the first seven years (Ex. 15, R. 2749). Even allowing for book deficits in the first two years, the net income available for dividends and surplus, during the first seven years, was $8,224,436, per the books (Ex. 136, R. 2959) or an annual average of 39.3% on the capital stock of Natural Gas Pipeline Company of America. For the first eight months of 1939 that company paid $1,500,000 on its $3,000,000 stock (Ex. 187, R. 3784).

[3] Standard Oil Company of New Jersey, The Texas Corporation, Columbian Carbon Company, Southwestern Development Company, Cities Service Company, and Natural Gas Investment Company. The last-mentioned company is in turn owned by The Peoples Gas Light and Coke Company and Commonwealth Edison Company (Chart 4, Exhibit 186, R. 3781).

More specifically, the total actual income available for return and for amortization of investment, according to the companies' exhibits, after payment of operating expenses and taxes, during the years from 1932 to 1938, inclusive, was $53,405,092 (Ex. 136, R. 2959). During the same period a total of $19,558,810 was charged to operations for amortization of investment, consisting of $11,620,210 on account of depreciation, $1,457,278 on account of depletion, and in addition, $6,481,322 for retirements beyond the amount charged against the depreciation and depletion reserves (Ex. 136, R. 2959). Deducting the total charges of $19,558,810 from the $53,405,092 of income leaves $33,846,282 for return on investment during the period, which is an average of $4,835,183 per annum, after all actual charges made by the companies for depreciation, depletion, and retirements.

The book cost of the properties existing each year, according to the companies' balance sheets, averaged slightly more than $60,000,000 during this period, or slightly less than $61,000,000 if the companies' estimate for working capital is included (Ex. 137, R. 2991).

At the end of the period the companies had accumulated reserves of $12,557,892 for depreciation and depletion applicable to the properties in service (Ex. 137, R. 2991). If we take this figure as the companies' measure of the loss in the existing properties that occurred in the seven years by reason of depreciation and depletion, and deduct one-

half of it from the undepreciated figure of $61,000,000, the average depreciated investment for the period is found to be approximately $54,720,000. The average annual income of $4,835,183 during the seven-year period was more than 8.8% of that investment (Ex. 137, R. 2993).

For the year 1938, the net earnings from operations ($9,884,745) (Ex. 136, R. 2959), after depreciation charges of $1,978,408, depletion charges of $261,658, and retirements of $992,567, as per the companies' books, amounted to $6,652,112. The actual book cost of the existing properties as of December 31, 1938, $59,197,842 (R. 2991), together with working capital as claimed by the companies of $975,000 (R. 3901), amounted to $60,172,842, or $47,614,950 after deduction of the depreciation and depletion reserves of $12,557,892 applicable to the existing properties (Ex. 136, R. 2959). The net earnings on the depreciated investment were thus almost 14% in 1938. Even without any deduction of the depreciation and depletion reserves, the return was approximately 11%. The earnings of the companies for the first eight months of 1939 were substantially larger than the corresponding earnings for 1938 (Ex. 187, R. 3784).

D. OPINION AND ORDER OF THE COMMISSION

On July 23, 1940, the Federal Power Commission issued its memorandum opinion (R. 3925–3942) and an interim order reducing rates (R. 3942–3946). After making subsidiary and ultimate findings, including a finding that the com-

panies' rates were "unjust, unreasonable, and excessive" (R. 3945), the Commission ordered the companies to file new schedules of rates and charges reflecting a reduction of at least $3,750,000 per annum in operating revenues; these new schedules were to be effective as to all bills regularly rendered on or after September 1, 1940 (R. 3945–3946). The order also provided that the record should "remain open for such further proceedings as the Commission may deem necessary or desirable" (R. 3946).

For the purpose of the interim order the Commission "reluctantly" accepted (R. 3936) the following estimates presented by the companies' own witnesses:

Reproduction Cost New of Physical Properties (exclusive of Gas Reserves)[4]	$56,302,250
Value of Gas Reserves as of June 1, 1939	13,334,775
Capital Additions from June 1, 1939, to December 31, 1942	3,808,390
Working Capital	975,000

[4] Although the Commission accepted the companies' estimate of reproduction cost new for purposes of its interim order, it seems clear from the record that that estimate is excessive. The very fact that the reproduction cost depreciated exceeds the actual cost new casts great doubt upon the reproduction figures since the property was constructed in 1930 and 1931; most of the contracts must therefore have been let in 1930 or before, a high price period. The estimate of $13,334,775 for the present market value of the leaseholds (Exs. 131, 146, R. 2949, 3069) appears plainly excessive when it is compared with the actual cost of those leases appearing in defendants' books as of December 31, 1938; the book figure for the then existing leases is $9,367,364 (Ex. 137, R. 2993) and it is subject to substantial reduction for depletion, the companies themselves having accrued a depletion reserve of $1,152,854 (Ex. 137, R. 2991).

These items total $74,420,424, which sum the Commission adopted as the rate base (R. 3937, 3944). The companies' own recorded book cost of the properties plus working capital, in existence as of December 31, 1939, was $60,952,279 (R. 3937).

The companies urged, on the other hand, a rate base of $82,291,553, computed as follows (R. 3935):

Reproduction Cost New exclusive of Gas Reserves	$56,302,250
Less "Viewed" Depreciation	2,866,758
Present Value of Physical Properties exclusive of Gas Reserves	53,435,492
Present Value of Gas Reserves	13,334,775
Allowance for Future Capital Expenditures	6,046,286
Going Value	8,500,000
Working Capital	975,000
Total	82,291,553

The Commission refused to include in the rate base the companies' claim of $8,500,000 as a separate allowance for "going concern" value and $2,237,887 for average future capital expenditures from 1943 to 1954, the date claimed by the companies for the exhaustion of their gas reserves and the termination of their business. The claim for "going concern" value was characterized by the Commission as "arbitrary" and a "deceptive fiction"; it stated in its opinion that it was convinced that it was allowing in the rate base "more than an adequate amount to cover all elements of value," and that the rate base allowed was "liberal" (R. 3936–3937). The claim for future capital expenditures from 1943 to 1954 was not included because "it is clear * * * that such

improvements are not used and useful in the present and to a certain extent must be deemed conjectural" (R. 3936).

The Commission fixed 6½% as the fair rate of return on the above-mentioned rate base (R. 3938–3940).

The Commission accepted the companies' own estimate of 23 years (1932–1954) as the life of their business, and their figures, $78,284,009, for total past and future investment, less salvage (R. 3938; see Ex. 140, R. 3021).[5] From this it calculated that "the annual amortization expense on an investment of $78,284,009 for a period of 23 years, at the 6½ percent sinking fund rate, is $1,557,852. We allow that amount" (R. 3938).[6]

The Commission also accepted for the purpose of the present order the companies' statement of income available for amortization and return for 1939 to 1942, inclusive (R. 3938), the average income for such years being $9,511,454 (Ex. 140, R. 3023). The Commission noted, however, the in-

[5] This figure is computed as follows:

Book cost of existing properties at December 31, 1938 (R. 2991)	$59,197,843
Retirements actually made (1932–1938) (R. 2991, 3021)	7,000,918
Future capital additions, replacements, and contingencies (1939–1954) (R. 3021)	12,159,380
Working capital (R. 3021)	975,000
Total	79,333,141
Less salvage (R. 3021)	1,049,132
	78,284,009

[6] The term amortization was used to mean an allowance for depreciation and depletion (R. 3937).

crease in federal income taxes provided by the Revenue Act of 1940, and estimated that the income available for amortization and return would be decreased to $9,362,032 (R. 3938). The Commission then concluded that the fair return, $4,837,328 (6½% of $74,420,424), exceeded the companies' estimate of return less the allowed amortization allowance ($9,362,032 less $1,557,852) by $2,966,852, which sum was available for reduction in net revenues. Because of the consequent reduction of $783,909 in federal income taxes, the order reduced the rates by $3,750,000 (R. 3941).

The Commission felt that the reduction was "conservative in view of the acceptance of the companies' estimates and the generous allowances" (R. 3941), and noted that the acceptance of reproduction cost testimony for the purpose of the order would not prevent the Commission from subsequently exercising its judgment "as to how reproduction cost evidence shall be ultimately treated * * *" (R. 3941).

E. ACTION OF THE COURT BELOW

Pursuant to Section 19 (b) of the Act, the companies petitioned the Circuit Court of Appeals for the Seventh Circuit for a review of the Commission's order (R. 3997–4009). The Circuit Court of Appeals upheld (1) the validity of the Natural Gas Act, (2) the authority of the Commission to issue an interim order reducing rates, (3) the propriety of setting 6½% as the fair rate

of return, and (4) the propriety of requiring the companies to file new rate schedules reflecting the amount of the reduction ordered. The court below vacated the Commission's order, however, on the sole grounds (1) that a separate allowance for "going-concern value" of $8,500,000 should have been included in the rate base, and (2) that the period of amortization chosen should not have been the entire life of the business, but rather either the period beginning with the passage of the Act or the period commencing with the date of the rate reduction order. The court made no finding that the reduction would result in unjust, unreasonable, or confiscatory rates.[7]

F. CONTENTIONS OF THE PARTIES

The Federal Power Commission and the Illinois Commerce Commission, petitioners in No. 265, challenge the holding of the court below that a separate allowance for "going concern" value should have been included in the rate base and that the period of amortization should not have been spread over the entire life of the business. The companies, petitioners in No. 268, challenge the constitutionality of the Natural Gas Act, and in

[7] The court found it unnecessary to consider two other grounds of attack urged by the companies: (1) that capital additions from 1943 to 1954 should have been included in the rate base, and (2) that 2% instead of 6½% interest should have been used in calculating the amortization allowance.

addition assert that under Section 5 (a) of the Act, the Commission must actually set rates and not merely limit profits, that the finding that the companies' present rates are unreasonable is not supported by substantial evidence, that the finding that 6½% per annum is a fair return is not supported by substantial evidence, that the Commission erred in computing the amortization allowance on the same rate of interest as allowed as a fair return, that the Commission had no authority to enter the "interim" order, that the order operates to confiscate the companies' property in violation of the due process clause of the Constitution, and that the companies did not have a fair hearing within the meaning of the Natural Gas Act.

SPECIFICATION OF ERRORS TO BE URGED IN NO. 265

The court below erred:

1. In holding that the Federal Power Commission was required to include in the rate base a separate allowance for going concern value.

2. In holding that, in computing the amortization allowance, the Commission should have taken as the period of amortization either the period beginning with the passage of the Natural Gas Act or the period beginning with the date of the rate order.

3. In vacating and setting aside the Commission's order.

SUMMARY OF ARGUMENT

I

The Natural Gas Act of 1938 is a valid regulation of interstate commerce as applied to these companies.

II

The procedure adopted by the Commission in entering an interim order directing the companies to file a new schedule of rates reflecting a $3,750,000 reduction in annual earnings was authorized by the Act. The companies had a full hearing on every aspect of the case, including both the jurisdictional and substantive issues, and the statutory requirement that an order be entered "after a hearing" was consequently satisfied.

The fact that the Commission did not itself fix a detailed rate schedule does not render its order invalid. The practice followed by the Commission in this case is a familiar one in rate regulation. It is impliedly authorized by Section 5 of the Act, which empowers the Commission to fix reasonable rates, and expressly authorized by Section 16, which empowers the Commission to issue "such orders as it may find necessary or appropriate to carry out the provisions of this Act."

III

On the merits of the Commission's order, two issues are before the Court. The first is whether the rates prescribed are confiscatory. The second

is whether the Commission exceeded its statutory power to determine "reasonable rates" upon finding that the existing rates are "unreasonable." In principle the constitutional and statutory questions are separate and distinct, for the legislature may command the use of one method of rate making whereas the Fifth Amendment may permit use of a different test in determining whether the prescribed rates are confiscatory. In deciding the constitutional issue, it is not material that the Commission did in fact adopt the present fair value test. The Court must determine for itself whether the Constitution protects the present fair value of the property or only the investment in the property and then must test the validity of the Commission's order in the light of the proper constitutional principle.

IV

The reduction in rates ordered by the Commission does not violate the companies' constitutional rights. The Commission properly refused to make a separate allowance in the rate base for "going concern" value, properly computed the amortization allowance, and fixed a generous rate of return.

A. The claim for going concern value is, on precedent, plainly untenable. It is settled by the decisions of this Court that a separate allowance need not be made where the physical assets have

been appraised "as part of an assembled whole" and that a valuation based on reproduction cost includes a sufficient allowance for going concern value notwithstanding that the reproduction cost estimate is exclusively attributable to physical assets. The rationale of the decisions is that, when a valuation is made on a reproduction cost basis, the result in itself reflects a going concern, for if properties were not actually a going concern they would have only a scrap value, much less than reproduction cost less depreciation. Moreover, this Court has specifically condemned the particular method of calculating going concern value adopted by the companies in this case. *Galveston Elec. Co.* v. *Galveston*, 258 U. S. 388.

On principle, the inclusion in the rate base of an allowance for going concern value is not required by the Constitution under any permissible theory of rate regulation.

B. The Commission made a proper allowance for amortization.

1. The Commission properly based its depreciation allowance on the cost rather than the fair value of the properties. This is entirely clear if, as we urge, the Constitution protects only the investment and not the fair value of the property. It is equally clear even if *Smyth* v. *Ames*, 169 U. S. 466, enunciates the applicable constitutional principle.

It is almost universal business practice to base the depreciation charge on cost in the computation

of net earnings. The net earnings, so computed, of unregulated enterprises and the yield upon their securities, which in turn is based upon such net earnings, form the basis upon which the rate of return allowed to a utility is determined. To base the annual depreciation allowance upon fair value in the case of a utility would result in an additional profit over and above a fair return.

2. The Commission also properly fixed the depreciation period as the entire life of the property. Depreciation is simply an operating expense representing the annual diminution of the service capacity of the property. Manifestly, some of the service capacity of the property was consumed in the eight and a half years which elapsed prior to the entry of the order.

Under the sinking fund method used by the Commission, the amount of depreciation, measured in terms of original cost, attributable to the period prior to the date of the rate order is less than the actual accrued depreciation and is less than the amount which, under proper accounting practice, the companies should have charged and in fact did charge for depreciation during this period. Therefore, whether the Constitution is deemed to protect the property or the investment, the Commission's action in this respect was valid.

3. The Commission properly concluded that the rate of interest to be used in computing the annual amount necessary to amortize the total in-

vestment should be the same as the rate of return. This is so because, under the sinking fund method, by allowing a 6½% return on the full rate base without any deduction for amortization, the Commission in effect allowed a 6½% return on both the unamortized portion of the rate base and on the amortization reserve. The use of a 2% interest rate in computing the amortization allowance, as the companies urge, would result in an excessive return to the companies because, in applying the rate of return to the undepreciated rate base as provided by the sinking fund method, the 6½% interest rate thus in effect applied to the amortization reserve is 4½% higher than the 2% rate of interest used in computing the amortization allowance.

C. The record amply supports the Commission's finding that 6½% is a fair rate of return.

V

The Commission's findings that the companies' existing rates are unreasonable and that the level of rates fixed by the Commission is reasonable are supported by substantial evidence. The companies' contention to the contrary proceeds on the assumption that the reasonableness of rates must be determined by the value and benefit of the service rendered, and that the fact that the existing rates yield millions in excess of a fair return on the value of the property is not sufficient evidence

to support a finding of unreasonableness. The contention is obviously without merit. The reasonableness of the rates must be measured either by a fair return on fair value or by a fair return on investment, and not by the value of the service to the consumer. And there can be no doubt that, under either the investment or fair value test, the rates charged by the companies were "unreasonable" and that the rates fixed by the Commission are "reasonable" in the statutory sense.

VI

The rule of *Smyth* v. *Ames*, 169 U. S. 466, which requires a fair return on the fair value of the property, is unsound and the case should now be overruled. The rule is based on the eminent domain principle of "just compensation" for a "taking" of property. The regulation of rates, however, is not a "taking" of property; it is simply the exercise of the legislative power to fix prices in the public interest. The sole question of validity, therefore, as in any other case of price regulation, is whether the regulation is reasonable.

The regulation of rates on the investment basis is clearly reasonable, although regulatory agencies may be free to adopt other methods warranted by business practice. On the basis of long experience, almost all informed opinion is agreed that effective rate regulation on a fair value basis is a practical impossibility, and that the investment standard is

sound and workable, is just to the utilities and will attract sufficient capital to secure adequate service.

ARGUMENT

I

THE NATURAL GAS ACT OF 1938 IS A VALID REGULATION OF INTERSTATE COMMERCE

The court below concluded "without much doubt" that the Natural Gas Act is constitutional (R. 4030). Its conclusion is plainly correct.

The sale, transportation, and delivery of natural gas from one state to distributors in any other state constitutes interstate comerce subject to regulation by Congress. *State Commission* v. *Wichita Gas Co.*; 290 U. S. 561, 563; *Public Utility Commission* v. *Attleboro Co.*, 273 U. S. 83, 90; *Peoples Gas Co.* v. *Public Service Commission*, 270 U. S. 550, 554; *Missouri* v. *Kansas Gas Co.*, 265 U. S. 298, 303. Admittedly the companies are engaged in that business.

The fixing of rates charged by the companies does not contravene the Fifth Amendment. In the field of interstate commerce, Congress may provide for administrative regulation of rates and charges without regard as to whether the business regulated is a "public utility," provided that the fixing of rates bears a reasonable relation to a proper legislative purpose. *Sunshine Anthracite Coal Co.* v. *Adkins*, 310 U. S. 381, 393–397. See also *Olsen* v. *Nebraska*, 313 U. S. 236; *United States* v. *Darby*, 312 U. S. 100; *United States* v. *Rock*

Royal Cooperative, 307 U. S. 533, 569; *Nebbia* v. *New York*, 291 U. S. 502. To protect the public against unreasonable charges for gas, light, and heat has traditionally been an appropriate legislative purpose. And regulation of the rates charged to the local distributor by gas pipeline companies is plainly a reasonable if not an essential step toward that end. Indeed, the extensive character of the investigation on which Congress based its findings that regulation of the business of transporting and selling natural gas for ultimate distribution to the public "is necessary in the public interest," is sufficient to rebut any charge of arbitrary and capricious action.

The question whether Section 7 of the Act is unconstitutional because it prohibits a company from withdrawing from the business is not before this Court. Quite apart from Section 7, the Act sets up a separable and workable system of rate regulation. The order appealed from fixes only rates. The companies have filed no application with the Commission for leave to withdraw from business and therefore cannot complain of any injury from this provision of the Act. Since the Act contains a separability clause in Section 23 and would be workable without Section 7, the Court need not now consider the constitutionality of Section 7. *Electric Bond & Share Company* v. *Securities & Exchange Commission*, 303 U. S. 419, 439.

In any event there can be little doubt that Section 7 is constitutional. Continued operation by

gas pipeline companies which are chief suppliers to local distributing utilities may often be necessary to the public convenience, for an essential supplier of a distributing utility stands in this respect in the same position *vis a vis* the public as the distributor itself. Consequently it is a reasonable regulation, except in cases of confiscation, to require such a corporation to show before it ceases operations that discontinuance of the service will not injure the public which the corporation has brought to rely upon it. Cf. *United Gas Co.* v. *Railroad Commission*, 278 U. S. 300, 308-309. To the extent that *Wolff* v. *Court of Industrial Relations*, 262 U. S. 522, has not been overruled by later decisions it is not persuasive here, for, as the Court pointed out in that case, different regulations are appropriate for different businesses. See 262 U. S. at 539.

II

THE NATURAL GAS ACT AUTHORIZED THE COMMISSION, AFTER GRANTING A FULL HEARING TO THE COMPANIES, TO ENTER AN INTERIM ORDER DIRECTING THE COMPANIES TO FILE A NEW SCHEDULE OF RATES REFLECTING A PRESCRIBED REDUCTION IN OPERATING REVENUES

The companies contend that, under the terms of the Act, the Federal Power Commission had no authority to enter the type of order here under review. First, they say that the Commission may enter a rate order only after the hearing is com-

pleted—in other words, that it lacks authority to enter an "interim" order. Second, they say that the order is invalid because the Commission did not fix just and reasonable rates in accordance with the Act but merely ordered the companies to file a new schedule of rates reflecting a prescribed reduction in operating revenues. We submit that both the Commission and the court correctly rejected these contentions.

A. The Commission acted properly in entering an interim order on the companies' evidence

Section 5 (a) of the Act provides that "Whenever the Commission, after a hearing * * * shall find that any rate * * * is unjust, unreasonable, unduly discriminatory or preferential, the Commission shall determine the just and reasonable rate * * * and shall fix the same by order". The only limitation upon the kinds of rate order which the Commission is authorized to issue is that the order must be made after "a hearing." That statutory requirement was met in the instant case. The companies had every opportunity to present all their evidence on both the jurisdictional and substantive aspects of the problem (R. 3931), cross-examined every witness for both the Federal Power Commission and the Illinois Commerce Commission (R. 3932), offered what rebuttal testimony they desired (R. 3932) and before the so-called interim order was entered stated that they had concluded their case (R. 4004). They

filed briefs and argued orally. In short there was a full hearing in every substantial sense. As the Commission very properly observed, defendants "cannot be heard to complain that they have not yet been able to examine on redirect their own witnesses who have not yet been cross-examined, nor is it essential to a full hearing on the motion before us that they be permitted to cross-examine or rebut witnesses who have not yet been offered by counsel for the commissions" (R. 3932).

It seems plain that the hearing required by Section 5 (a) is a hearing in this substantial sense and not the technically completed proceeding to which the companies refer. The purpose of the requirement is simply to ensure that the Commission will act upon evidence and give the utility an opportunity to know, and to meet if it can, the claims, and evidence in support of them, upon which any order will be based. Accordingly, this Court in applying the Transportation Act of 1920 held (*New England Divisions Case*, 261 U. S. 184, 201):

> A hearing may be a full one, although the evidence introduced does not enable the tribunal to dispose of the issues completely or permanently; and although the tribunal is convinced when entering the order thereon, that, upon further investigation, some changes in it will have to be made.

To read the Natural Gas Act in the same manner carries out its purpose that rates shall always be reasonable. It enables the Commission, as it

did in the instant case, to hear the utility in full and then make findings and lower the rates to a level which appears reasonable on the evidence most favorable to the utility, such rates to be effective while the Commission continues the hearing to determine whether the rates should be still further reduced. On the other hand, the construction urged by the companies would serve no substantial purpose for the Commission could legitimately achieve the same result by the cumbersome process of opening and closing a succession of hearings.

Moreover, Congress evidently intended the Commission to have this salutory power to enter a rate order without regard to the technical distinctions between an interim order after a full hearing in a pending proceeding and a final order after a proceeding is closed, for in Section 16 it provided, "The Commission shall have power to * * * issue * * * such orders * * * as it may find necessary or appropriate to carry out the provisions of this Act."

The failure to include in the Act power to enter orders fixing temporary rates, after the analogy of the New York and Pennsylvania statutes,[8] is no indication of a contrary intention; there is a vast distinction between fixing rates on the basis of the utility's own case at a time when the hearing could

[8] See *Driscoll* v. *Edison Co.*, 307 U. S. 104; *Matter of Bronx Gas & Electric Co.* v. *Maltbie*, 271 N. Y. 364.

be closed and prescribing a rate on the basis of the utility's original cost less reserve before the utility has had full opportunity to present all its evidence. In this case the Commission has not fixed nor sought to defend the level of rates prescribed by the interim order on any basis that would not be equally applicable to a final order. Cf. *Driscoll* v. *Edison Company*, 307 U. S. 104. The Commission has considered all evidence relevant on any theory of rate making and the validity of its order on the merits is to be tested by the same principles which would govern the validity of any final rate order.

B. The Commission acted properly in directing the companies to file a new schedule of rates reflecting a prescribed reduction in operating revenues

The companies' contention that the order is invalid because it does not fix a schedule of rates ignores the twofold character of rate regulations. One branch is to determine the general rate level; the other is to cure maladjustments, discriminations, and unfairnesses in the details of the schedule. The two may properly be separated and either dealt with alone in such a way as to meet the essential problem before the regulatory body. Particularly that has been true where, as in the instant case, the hearings reveal that a blanket change is needed as well perhaps as detailed adjustments; the former has not been made to wait on the latter.

The Interstate Commerce Commission has long recognized the difference and framed its orders

to the general rate structure or the particular tariff according to the problem before it. *New England Divisions Case,* No. 646, October Term 1922, Brief for Interstate Commerce Commission, pp. 65, 67–76. And this Court has held that the Interstate Commerce Commission has power in fixing rates and divisions to deal with the major over-all controversy and leave the detailed schedules for the carriers to develop in the first instance. *New England Divisions Case,* 261 U. S. 184, 201–202.

Similarly, it is an accepted practice for state commissions to order utilities to make such a reduction in rates as will reflect a prescribed decrease in operating revenues. *E. g., Driscoll* v. *Edison Co.,* 307 U. S. 104, 107.

Under the Natural Gas Act the Commission likewise has power to mould and limit its order to meet the needs of the real controversy. Section 5 is modeled after the provisions of the Interstate Commerce Act and Transportation Act of 1920 which had been interpreted to give the Interstate Commerce Commission that power. Moreover, Section 16 provides that the Commission may issue any order which it finds necessary or appropriate to carry out the provisions of the Act. In the present case the real controversy was over the general rate level and not any particular rate, and the hearings had revealed a rate structure far higher than the reasonable levels prescribed by

Section 4. Consequently, it was appropriate to meet that problem by ordering a general reduction without delaying to hear evidence and make a final order upon the details of a precise schedule with which no one was then concerned. Indeed, the companies can scarcely be heard to complain because they were given the right to present for Commission approval the precise rates and charges. As the court below pointed out, such treatment is "more favorable" to them than the promulgation of an entire schedule (R. 4032).

III

THE ISSUES BEFORE THIS COURT ON THE MERITS

Section 19 (b) of the Act provides:

> (b) Any party * * * aggrieved by an order issued by the Commission * * * may obtain a review of such order in the circuit court of appeals * * * by filing * * * a written petition praying that the order of the Commission be modified or set aside in whole or in part. * * * The finding of the Commission as to the facts, if supported by substantial evidence, shall be conclusive. * * * The judgment and decree of the court, affirming, modifying, or setting aside, in whole or in part, any such order of the Commission, shall be final, subject to review by the Supreme Court. * * *.

The present proceedings were instituted pursuant to this section.

Two issues on the merits are before the Court. The first is whether the rates prescribed by the Commission are confiscatory in nature, i. e., whether the due process clause of the Constitution has been violated. The second is whether the rates prescribed by the Commission are beyond its statutory power to determine "reasonable rates" upon a finding that the existing rates are "unreasonable" or are "not the lowest reasonable rates" (Sec. 5 (a)).

In so far as the Congress has adopted the measure of constitutional validity as the basis for determining statutory reasonableness, the answer to both questions may turn on the same considerations of fact. In principle, however, the statutory and constitutional questions are separate and distinct and the distinction has an important effect on the scope of judicial review in this case.

The legislative methods which may be prescribed by Congress for rate making are not necessarily the same as the constitutional principles by which the validity of the legislative methods or the rates ordered pursuant thereto must be tested. The scope of statutory authority must be measured by the command of the legislature; the test of constitutionality is drawn from the Constitution. The distinction between statutory and constitutional requirements, obvious enough in most cases where questions of both statutory authority and constitutional validity are involved, would be clear in a rate case if the prescribed legislative method were based

on the prudent investment principle and the test of constitutionality drawn from the Fifth Amendment were fair value. In such a case it would not seriously be suggested that the Court was bound to apply the prudent investment principle as the test of constitutional validity of rates merely because the legislature had adopted this standard as the basis of statutory authority, although the legislative action would be persuasive of its reasonableness where the test of validity drawn from the Constitution is reasonableness.

This Court recognized the distinction in *Los Angeles Gas Co.* v. *Railroad Commission,* 289 U. S. 287, 304–305, where the Court rejected a contention that an order of a state utility commission, based in substance on the prudent investment principle, was invalid because of the method employed by the commission. The Court, speaking through Chief Justice Hughes, declared:

> * * * We do not sit as a board of revision, but to enforce constitutional rights. *San Diego Land & Town Co.* v. *Jasper,* 189 U. S. 439, 446. The legislative discretion implied in the rate making power necessarily extends to the entire legislative process, embracing the method used in reaching the legislative determination as well as that determination itself. We are not concerned with either, so long as constitutional limitations are not transgressed. When the legislative method is disclosed, it may have a definite bearing upon the validity of the result

> reached, but the judicial function does not go beyond the decision of the constitutional question. That question is whether the rates as fixed are confiscatory. And upon that question the complainant has the burden of proof and the Court may not interfere with the exercise of the State's authority unless confiscation is clearly established.

The conclusion is the same where the legislative method prescribed or authorized by the statute is fair value. The Court is obviously not bound to apply the statutory standard as the measure of constitutional validity. The distinction has been lost sight of largely because the utility commissions have adopted the rule of *Smyth* v. *Ames* as the legislative method of rate making, with the result that the administrative and constitutional inquiries have been the identical one of determining the present fair value of the utility. As Mr. Justice Brandeis observed in his concurring opinion in *Southwestern Bell Tel. Co.* v. *Public Service Commission*, 262 U. S. 276, 289, 296:

> The rule there stated [in *Smyth* v. *Ames*] was to be applied solely as a means of determining whether rates already prescribed by the legislature were confiscatory. It was to be applied judicially after the rate had been made; and by a court which had had no part in making the rate. When applied under such circumstances the rule, although cumbersome, may occasionally be effective in destroying an obstruction to justice, as the action of a court is, when it sets aside

> the verdict of a jury. But the commissions undertook to make the rule their standard for constructive action. They used it as a guide for making, or approving, rates. And the tendency developed to fix as reasonable, the rate which is not so low as to be confiscatory. * * *

The action of the Commission in this case in adopting fair value as the rate base and original investment as the amount to be amortized, thus presents two questions: First, whether the Commission was authorized by the statute to fix reasonable rates on this basis; and second, whether the Constitution condemns the legislative method or result. We show below that the Commission's action was authorized by the Act. See *infra*, pp. 106–112. We also show below that, even if the measure of constitutional validity is that announced in *Smyth* v. *Ames*, the companies have not been denied any constitutional rights. For the reasons set forth above, however, the Court is at liberty to determine whether the standard of validity to be drawn from the Constitution is that of prudent investment. To be sure, if the present fair value standard, adopted by the Commission pursuant to statutory authority, were itself challenged as unconstitutional, the legislative adoption might be of significance in determining constitutional reasonableness. But where, as here, the challenge is that this standard was not faithfully applied, this Court may reject the chal-

lenge if the Constitution protects only the investment and if the rates, as we show below, are in excess of what the Constitution, as thus construed, requires.

We proceed, then, to a discusssion of the issues on the merits. We propose to show in that discussion that the rates were reasonable in a statutory sense and that they were not confiscatory in a constitutional sense. Since judicial consideration of the questions of going concern value and amortization have normally been presented to the courts in constitutional cases, we discuss the constitutional issue first. The principles discussed in the portion of the brief devoted to the constitutional issue, however, are very largely applicable to the question of the reasonableness of the rates in the statutory sense.

IV

THE REDUCTION IN RATES ORDERED BY THE COMMISSION DOES NOT VIOLATE THE COMPANIES' CONSTITUTIONAL RIGHTS

The companies urge that the Commission erred in failing to make a separate allowance for "going concern" value, in the computation of the amortization allowance, and in fixing the rate of return at 6½%. We propose to show that the Commission's action with respect to each of these items was correct and accordingly that the claim of violation of the companies' constitutional rights—as well as the claim that the reduced rates

ordered are not "reasonable" within the meaning of the statute—is without substance.

In this section of the brief, we discuss the companies' contentions on the assumption that the Constitution requires a fair return on "present fair value." In a subsequent section of the brief, however, we urge that this Court should now declare that the only requirement imposed by the Constitution is that a fair return be allowed upon net investment.*

We emphasize now this argument which we make later in the brief for the reason that much of the confusion in the cases with respect to going concern value and amortization is attributable to a failure by the courts to comprehend that the treatment to be accorded these items depends, in part at least, upon whether the "present fair value" or "investment" test is used. For pur-

* For purposes of this brief the following definitions will be adopted:

"Investment"—the amount reasonably and honestly invested by the present owner in the public utility properties used and useful in the public service.

"Original cost"—the actual legitimate cost of the property to the company first devoting it to the public service. In this case, "investment" and "original cost" are the same.

"Net investment"—gross investment subject to reduction for the proper amount of depreciation.

"Net original cost"—the original cost less related depreciation, amortization, and depletion reserves.

"Reproduction cost"—the estimated cost of reproducing the existing property of the utility which is used and useful in rendering public service.

poses of clarity, therefore, we not only show in this section of the brief that the Commission's treatment of going concern value and amortization was correct under the "present fair value" rule, but also point out the relation of the issues discussed to the "investment" test.

A. The Commission Properly Refused to Make a Separate Allowance for Going Concern Value

1. The facts with respect to the companies' claim for a separate allowance for going concern value

The Commission adopted the companies' estimate of reproduction cost in fixing the rate base (R. 3937), but refused to make a separate allowance of $8,500,000 claimed by the companies as "going value." In doing so the Commission declared that the rate base was "liberal" and that it had allowed "more than an adequate amount to cover all elements of value" (R. 3936–3937). The companies contend that their estimate of reproduction cost was based solely on the cost of replacing the physical elements and excluded any element of intangible value, and that, according to the uncontradicted testimony of the companies' witnesses, the property had an additional intangible or "going value" of $8,500,000. They urge that the Commission erred both in that it failed to consider "going value" at all and in that it failed to find this value in the amount of $8,500,000 (Br. pp. 68, 101). While they purport to dis-

avow any contention that the physical and intangible values must be separately appraised (Br. p. 68), their claim for an allowance additional to that which they claim for the physical properties obviously comes to the same thing.

The rate base adopted by the Commission included, in addition to labor and material costs, large amounts for overhead, interest, taxes, administrative, legal and supervisory charges, and expenses of preliminary operations (R. 1221–1234). The companies claim, in addition, the right to capitalize costs allegedly incurred during the early period of operations until the development of subsequent capacity. Specifically, these costs are alleged to consist of advertising and promotional expenditures, interest allocated to a portion of the capacity not completely used prior to development of full capacity, taxes allocated to such facilities, depreciation allocated to such facilities, and operating expenses and maintenance costs on the facilities (Br. p. 55). These costs are claimed to be "actual" costs notwithstanding that the facilities were in actual use during the period, although not used to full capacity. The claim is not limited to the two-year period when the companies allegedly were operating at a loss (Ex. 136, p. 1, R. 2959), but embraces all four years, 1932 to 1935, inclusive, during which operations failed to reach the so-called

normal operating level of the 1936–1938 period, when the companies operated at a rate which equalled so far as practicable the maximum operating capacity of the physical properties. (R. 1330, 1278.)[10] On this method of calculating going concern value, as the companies' witness Emery

[10] The companies' witness, Hamilton (R. 1276–1282), took the average revenues for the fifth, sixth, and seventh years of operation (1936–1938), during which the companies operated at about 92 per cent of theoretically maximum capacity. This figure, $14,847,112, he reduced to $12,372,593 because of increased capacity after 1936. He then ascertained the revenues for 1932, 1933, 1934, and 1935 (the years in which the business was being attached) and divided each year's revenue by the average revenues of $12,372,593 and arrived at the percentage of actual revenue to capacity revenue for those years, and by deducting each percentage from 100 per cent he arrived at the nonproductive capacity of the plant for those years—52.7% for 1932, 49.5% for 1933, 23.3% for 1934, and 2.7% for 1935. He then applied these percentages to interest paid on money, taxes paid, depreciation expense, and operating expense and found $6,664,192 as the expense supposed to be attributable to nonproductive capacity, to which he added $1,567,372, the total actual cost of advertising and similar direct expenditures for attaching business during the years 1932–1935, and arrived at the figure of approximately $8,500,000 for "going value." Emery's method was similar (R. 1327–1337). He likewise took the years 1936, 1937, and 1938, as the time during which the companies were operating substantially at maximum capacity and found that the "lag in attaching business" (R. 1330) was 51.98% in 1932, 56.75% in 1933, 21.42% in 1934, and 3.63% in 1935. Applying these percentages to the interest expense, general expense, and depreciation expense and adding "cost of attaching business" he arrived at practically the same result as Hamilton.

frankly conceded (R. 1951), the going value would have been correspondingly increased if operating charges had been greater because of inefficiency. Similarly, Emery testified that if bond interest or taxes had been larger, going value would presently be greater (R. 1957). So, too, he admitted that if existing depreciation be greater than that testified to by the companies' witness on "observed depreciation," going value would be greater (R. 1958).

The companies' claim for an $8,500,000 allowance for development costs as part of present fair value seems patently absurd in the light of the record in this case, which shows that there was never any real risk that early deficits in earnings due to development costs would not be amortized out of subsequent earnings or any real potential difficulty in creating a sufficient consumer demand within a short period. The original investors in the enterprise included the owners of three large gas distribution systems in and about Chicago (R. 2088) and before operations began the companies secured a 15-year contract, renewable for five years at their option, with the Chicago District Pipeline Company, under which the latter purchases 90% of the companies' gas and resells it to the three distributing companies in the Chicago area (R. 585, 2088, 2063). These distributing companies, which furnish the gas requirements of the Chicago area,

one of the richest and most populous in the country, had a substantial investment in the companies in this case (R. 2088), and guaranteed the contract with Chicago District Pipeline Company (R. 3).

The companies themselves regarded the risk of early deficits as negligible. Thus, the original estimates which they submitted to the Illinois Commerce Commission in 1931 (Ex. 156, R. 3334) before they began operations, in justifying the reasonableness of their charges to the distributing companies, disclosed an expected average return of only 6.3%, and this on the assumption that their gas reserves would be exhausted in 15 years. That the companies considered this expected average rate of return, which they now contend is insufficient even for a going concern, sufficient to warrant a large investment in a new enterprise, is clear proof that they discounted any risk that early development expenses could not be quickly paid out of subsequent earnings without capitalization for the total life of the enterprise.

The return earned by the companies has in fact far exceeded their expectations, and the development costs have already been many times recouped. During the years 1936 to 1938, the period of full operation, the companies made enough to pay all operating, maintenance and general expenses, provide for depletion, depreciation and retirements, and to earn in addition 11.9 percent on their gross

investment.[11] The various items claimed as going value have already been charged to operating expenses and in fact paid for by the consumers (Ex. 136, p. 1, R. 2959; Ex. 136, p. 2, R. 2961). Even if the entire sum of $8,500,000 claimed as "going value" be deducted from the net earnings available for return in the three years from 1936 through 1938, the companies would still have earned an average of 7.28% on the undepreciated investment during the years 1936 to 1938. See footnote 11, below. During the period 1932 to 1938, inclusive, the average annual return was 8.1% on the undepreciated investment and 8.8% on the approximate

[11] This is shown by the following table:

	1936	1937	1938
Capital Assets (Ex. 137, R. 2991)	$59, 529, 748. 76	$59, 436, 823. 31	$59, 197, 842. 69
Working Capital (Ex. 141, R. 3025)	975, 000. 00	975, 000. 00	975, 000. 00
Total	60, 504, 748. 76	60, 431, 823. 31	60, 172, 842. 69
Net Earnings Before Other Charges (Ex. 136, R. 2959)	10, 343, 134. 88	10, 796, 261. 76	9, 910, 662. 19
Depreciation, Depletion, and Retirements (Ex. 136, R. 2959)	3, 207, 293. 21	2, 293, 109. 79	3, 232, 633. 63
Net Earnings Available for Return	7, 135, 841. 67	7, 864, 151. 97	6, 678, 628. 56
Total Undepreciated Cost of Property, plus Working Capital (1936, 1937, 1938)			181, 109, 414. 72
Total Net Earnings Available for Return (1936, 1937, 1938)			21, 678, 022. 20
Average Return on Undepreciated Rate Base (percent)			11. 9
Net Earnings Available for Return less $8,500,000 claimed by the Companies for Going Value			13, 178, 022. 20
Average Return on Undepreciated Rate Base after Deducting from Return the Total Amount Claimed for Going Value (percent)			7. 28

average depreciated investment,[12] much greater than expectations. The return of 6.5% now allowed to the companies as an established enterprise exceeds that contemplated by the companies prior to the commencement of the business. To permit capitalization of these alleged charges already recouped would be to permit an inordinate return.[13]

2. The controlling decisions of this Court support the Commission's denial of the companies' claim

On precedent, the companies' claim for a separate allowance for going concern value is plainly untenable. This Court has held that "going

[12] As appears from Exhibit 136, p. 1 (R. 2959) the companies' total earnings in the seven years 1932 to 1938, inclusive, amounted to $8,244,435.79 net profit, to which must be added $23,994,029.98, interest on bonds, and $1,802,416.57, bond discount. Taking $60,000,000 as approximate average investment, the average annual earnings were 8.1% prior to regulation, an amount sufficient to amortize any possible loss during the first three "developmental" years. The return on the approximate average depreciated investment was 8.8% (see p. 11, *supra*).

[13] Even the companies themselves admit (Br. 163) that their average annual earnings for the first seven years of operations (1932–1938) were $1,234,118.88 per year above the amount allowed by the Commission. This is a total of $8,639,316.00, or more than the amount claimed for going value. This does not take into account similar or greater excess earnings from the end of 1938 to the date of the Commission order in July 1940. See Ex. 187, R. 3784, showing increase in net earnings of the companies of $790,318.00 for the 8 months ended August 31, 1939, as against the same period in 1938, and an increase of $1,228,984.00 in net earnings available for dividends after depreciation, depletion, retirement, and fixed charges.

value" must be considered by the rate-making agency "upon proof of its existence". *Dayton P. & L. Co.* v. *Public Utilities Commission,* 292 U. S. 290, 308; *Los Angeles Gas Co.* v. *Railroad Commission,* 289 U. S. 287, 314. It is now settled, however, that a separate or additional allowance for such value is not required where the physical assets have been appraised "as part of an assembled whole." *Columbus Gas & Fuel Co.* v. *Public Utilities Commission,* 292 U. S. 398, 411; *Dayton P. & L. Co.* v. *Public Utilities Commission,* 292 U. S. 290, 309; *Denver Stock Yard Co.* v. *United States,* 304 U. S. 470, 478–480; cf. *Des Moines Gas Co.* v. *Des Moines,* 238 U. S. 153, 171. Accordingly, a valuation based on reproduction cost includes a sufficient allowance for intangible going value even though the estimate of replacement cost is "exclusively attributable to physical elements." *Denver Stock Yard Co.* v. *United States,* 304 U. S. 470, 479; *Dayton P. & L. Co.* v. *Public Utilities Commission,* 292 U. S. 290, 309; cf. *Des Moines Gas Co.* v. *Des Moines,* 238 U. S. 153, 171; *Columbus Gas & Fuel Co.* v. *Public Utilities Commission,* 292 U. S. 398, 411; *Driscoll* v. *Edison Co.,* 307 U. S. 104, 117."

"The opinion of Mr. Justice Butler in *Denver Stock Yard Co.* v. *United States, supra,* suggests that an additional allowance for "going value" might be justified on a showing of an unusual ability to earn at "low rates" as compared with other like utilities (304 U. S. at 480), a suggestion which he had previously advanced in *McCardle* v. *Indianapolis Water Co.,* 272 U. S. 400, 413–415. See also his dissenting

The rationale of these decisions is that when the physical properties and the incidental rights have once been appraised both as to primary valuation and deduction for depreciation, the result in itself reflects a going concern value, for the total amount constitutes valuation from the standpoint of a successful enterprise. It presupposes attached customers, a given demand for services, and appropriate business organization and management. If the properties were not actually a going concern and were not regarded as such, their valuation would be very much less than reproduction cost less depreciation; practically, all the plant and equipment units would have only a scrap or sacrifice sale value. Plainly, therefore, the fact that the utility is a going concern is reflected in every item and every assumption contained in a reproduction cost valuation. See Bauer and Gold, *Public Utility Valuation,* pp. 306–307.

Under the decisions cited, the Commission here clearly gave due consideration to the intangible element of going concern value, because the reproduction new estimate which it used to compute the rate base was based on the cost of reproducing the

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opinion in *Los Angeles Gas & Electric Co.* v. *Railroad Commission*, 289 U. S. 287, 324–325. Whether earning power at reasonable rates may properly be considered in a rate proceeding in which the inquiry is the reasonableness of the rates is a question considered below. See *infra*, p. 58. It is sufficient for present purposes to note that the companies make no claim for going concern value based on relative earning power.

properties as an assembled whole and because the Commission found, on all of the evidence, that the rate base allowed was "more than an adequate amount to cover all elements of value" (R. 3936–3937).

The Court should note the confusion in the companies' argument that the Commission, in adopting the companies' estimate of reproduction cost as the present value of the physical property, excluded any intangible going concern value. The argument is based on the fact that the companies' engineers referred to their reproduction cost appraisal as a "valuation" of the physical properties and stated that it did not include anything for going value. The obvious answer is that these witnesses did not determine value; they only made an estimate of the cost of reproducing the properties. The Commission and the Commission alone is the proper agency to determine the value which is to be used as the rate base. Upon a consideration of the record and for purposes of this case, the Commission took the figure represented by the companies' reproduction cost estimate as the value of the properties as an assembled whole, covering all elements of value.

The Commission was not required to give any consideration to the particular estimate of $8,500,000 going value prepared by the companies' witnesses. This estimate was based on the theory that going value is the difference between the

value of the physical plant alone without customers attached and the value of a plant with the maximum number of customers attached from the outset, that this value is measured by the cost of attaching such customers, and that such cost is in turn determined by the theoretical cost of maintaining the theoretically unused capacity and personnel in addition to the out-of-pocket operating expenses for promotion, advertising, and the like already charged to operating expenses. See pp. 40–41 *supra*. The estimate, consistently with the underlying theory, includes in the cost of attaching business the charges thus attributed to unused capacity during years in which there was no deficit as well as during those in which operating deficits were allegedly incurred, presumably in the view that the utility is entitled as a matter of economic fact and constitutional right to commence operations with a full complement of maximum business instantaneously attached.

This method of calculating going value was specifically condemned by this Court in *Galveston Electric Co.* v. *Galveston*, 258 U. S. 388, 394–395. See also *Columbus Gas & Fuel Co.* v. *Public Utilities Commission*, 292 U. S. 398, 411–413; *Dayton P. & L. Co.* v. *Public Utilities Commission*, 292 U. S. 290, 309; *Los Angeles Gas Co.* v. *Railroad Commission*, 289 U. S. 287, 313. In the *Galveston* case, this Court held that a lag in earnings in the development years and due to development

costs could not be capitalized and included in the rate base where the rate base was predicated on present value. This ruling was followed in the other cases cited. The method of calculation employed in this case differs from that condemned in the *Galveston* case only in that it includes as a cost of attaching business not only the charges attributed to unused capacity and the like during the period of alleged early deficits but also those incurred after the property was put on a paying basis but before the full load was developed. It seems obvious, however, that if the Constitution does not guarantee the ability to earn a fair return (*Galveston Elec. Co.* v. *Galveston, supra,* at 394–395), *a fortiori* it does not guarantee a utility the ability to reach its full unregulated earning capacity immediately.

It is true that the companies were not subject to federal regulation at the time these alleged costs were incurred and it may be assumed for purposes of argument that the Commission may not retrospectively reduce the companies' past earnings. By the same token, however, the Commission cannot be required to permit the companies to charge present customers an amount sufficient to make up for their failure to realize maximum unregulated earnings in the past, beginning with the moment of commencement of operations. Where present value is the basis of rate regulation, "Deficits in the past do not afford a legal basis for invalidating rates, otherwise compensatory, any more than past

profits can be used to sustain confiscatory rates for the future." *Los Angeles Gas Co.* v. *Railroad Commission,* 289 U. S. 287, 313.

The companies contend that the cases we have cited merely hold that the allowance for development costs depends on the history of the particular enterprise (cf. *Los Angeles Gas Co.* v. *Railroad Commission, supra,* at 314) and that the costs claimed in this case, unlike those alleged in the other cases, were actually incurred and should therefore be capitalized as part of the investment. While there is language in the cases to support this distinction, the decisions may not be so narrowly construed. The deficits allegedly incurred in the *Galveston* case were no less a necessary cost of development than the charges claimed here.[15] Thus, the opinion of Mr. Justice Brandeis recog-

[15] The principal difference between the *Galveston* case and the present one is that in the former the deficits were determined on the basis of an assumed fair rate of return (not challenged as unreasonable) (258 U. S. at 394) whereas here the companies were financed almost entirely by the issuance of 6 percent bonds sold at a discount to affiliated companies (Ex. 137, R. 2991) and the development costs, insofar as they depend on return on investment, were calculated on the basis of interest actually paid on the bonds. This distinction is immaterial. If the cost of money is to be considered a development cost during the early years of the enterprise, it can make no difference on a present value theory of rate valuation in what form the investment is made, whether in exchange for stock or for bonds. Obviously the value of the companies is not enhanced by reason of the fact that the enterprise was financed principally by the sale of bonds to affiliated companies which also purchased all of the stock which was issued (R. 2070–2071).

nized that, if a fair return were to be calculated on the amount "prudently invested", the funds "necessarily expended at the start in overcoming initial difficulties incident to operation and in securing patronage" (258 U. S. at 394) might with "propriety" be included in the investment base; he concluded, however, that such development costs need not be considered on a present value basis since "Past losses obviously do not tend to prove present value." 258 U. S. at 395. A contrary view would lead to the absurd conclusion that "base value [should] be deemed less in law if there was no development cost, because success was instant and continuous." *Id.* at 396.

The companies' attempted distinction (Br. p. 97) of the *Columbus* and *Dayton* cases is equally unavailing. While the language of the opinions in both cases (292 U. S. at 309; *id.* at 412–413) furnishes some support for the contention that the deficits there claimed were not actually incurred or were not due to the initial difficulties of operations, the fact is that the companies' witness Emery gave or supervised the testimony on going value in the *Dayton* and *Columbus* cases which was similar to and was based on the "same general principles" as his testimony in this case (R. 1961).

The only decision of this Court cited by the companies in support of the specific method of calculating going value here advanced is *City of Fort Smith* v. *Southwestern Bell Telephone Co.*,

270 U. S. 627, affirming without opinion *Southwestern Bell Telephone Co.* v. *City of Fort Smith;* 294 Fed. 102 (D. Ark.). In that case the District Court declared that a computation of the cost of attaching customers, similar to that made by the companies' witnesses in this case, was not subject to the objection that this Court had found in the estimate of going value in the *Galveston* case. 294 Fed. at 104. The affirmance of the decision by this Court, however, does not aid the companies. The city's own witness had conceded that the rate allowed by the city would have permitted less than his own estimate of a fair return on present value (294 Fed. at 108) and the cases cited by this Court in affirming leave no doubt that this was the ground on which it sustained the decree enjoining the enforcement of the prescribed rate. The Court cited *Newton* v. *Consolidated Gas Co.,* 258 U. S. 165 at 175, where it was said that "mere past success could not support a demand that it [the utility] continue to operate indefinitely at a loss"; *Galveston Electric Co.* v. *Galveston,* 258 U. S. 388, 395, announcing the companion doctrine that "Past losses obviously do not tend to prove present values"; and three other cases which, at the pages cited, merely declared that present value is controlling in rate valuation. It seems clear, therefore, that this Court affirmed the judgment of the District Court on the ground that the rate of return, based on present value, was concededly confiscatory, and

that it cited the *Newton* and *Galveston* cases as illustrative of the present value principle. It may be observed that in the only case in which this Court has cited the *Fort Smith* case, it did so on the question of the rate of return required to avoid confiscation. See *United Railways* v. *West*, 280 U. S. 234, 252n.

3. On principle, the inclusion in the rate base of an allowance for going concern value is not required by the Constitution under any permissible theory of rate regulation

The discussion in the preceding pages demonstrates that the decisions of this Court require rejection of the companies' contentions on the question of going concern value. The companies suggest, however, that in view of the confusion in regulatory practice resulting from the ambiguities in the opinions of this Court, the subject of going concern value in rate valuation should now be reviewed on principle. With that suggestion we are in entire agreement.

The ambiguities in the opinions of the Court are manifest. The Court has frequently said that going concern value must be given consideration and in two cases (*Denver* v. *Denver Union Water Co.*, 246 U. S. 178, 192; *McCardle* v. *Indianapolis Water Co.*, 272 U. S. 400, 413–415) has sustained a decree enjoining a rate as confiscatory because, among other reasons, it was insufficient to allow a return on going value. In the decisions cited, and particularly in the *McCardle* case, the Court

seemed to require an allowance separate from and in addition to that for the physical properties. But in other decisions rendered both prior to the *McCardle* case (*Cedar Rapids Gas Light Co.* v. *Cedar Rapids,* 223 U. S. 655, 669; *Des Moines Gas Co.* v. *Des Moines,* 238 U. S. 153, 171) and subsequent thereto (*Dayton P. & L. Co.* v. *Public Utilities Commission,* 292 U. S. 290, 309; *Columbus Gas & Fuel Co.* v. *Public Utilities Commission,* 292 U. S. 398, 411; *Denver Stock Yard Co.* v. *United States,* 304 U. S. 470, 479) the Court has held that a valuation based on an appraisal of the physical assets in actual operation is sufficient, since a plant without business attached would be worth much less. While the Court has emphasized that going concern value depends on the history of the particular enterprise (*Houston* v. *Southwestern Bell Telephone Co.,* 259 U. S. 318, 324–325; *Los Angeles Gas Co.* v. *Railroad Commission,* 289 U. S. 287, 314), it has declined to consider either past deficits (*Galveston Elec. Co.* v. *Galveston,* 258 U. S. 388) or past success (*Newton* v. *Consolidated Gas Co.,* 258 U. S. 165, 175) in determining present value. See Whitten-Wilcox, *Valuation of Public Service Corporations* (2d ed. 1928), p. 1369. And, since the *McCardle* case, the Court has consistently rejected as lacking in the "requisite persuasiveness" (*Los Angeles Gas Co.* v. *Railroad Commission, supra,* at 317) every estimate of going concern value which the ingenuity of professional expert witnesses has been

able to devise. *Los Angeles Gas Co.* v. *Railroad Commission supra; Dayton P. & L. Co.* v. *Public Utilities Commission, supra; Columbus Gas & Fuel Co.* v. *Public Utilities Commission, supra; Denver Stock Yard Co.* v. *United States, supra; Driscoll* v. *Edison Co.*, 307 U. S. 104, 117; see Hale, *The "Fair Value" Merry-Go-Round*, 33 Ill. L. Rev. 517, 525–531. This Court should now hold, we submit, that inclusion in the rate base of the going value of customers attached is not required under any permissible theory of rate regulation.

(a) In approaching the issue on principle, two fundamental premises must be kept in mind: *first*, that any value which is attributable solely to the monopoly position of the regulated company need not be included in the rate base; and, *second*, that any value which is based, directly or indirectly, on the earning power of the regulated company also need not be included in the rate base.

The first of these premises is obvious. A legitimate function of rate regulation is to eliminate the evils which, but for the regulation, would be caused by the monopolistic position of the regulated utility. In the case of a private, unregulated business, the prices charged are more or less effectively regulated by actual or potential competition. The rates of a monopolistic utility, on the other hand, are subject to no such competitive check. To assure that the rates will nonetheless be reasonable, the community must and does undertake to regulate

them. Plainly, however, in seeking to ascertain what is a "reasonable" rate the rate making agency may at least prevent the exaction of any rates in excess of those which would be charged under conditions of competition. Any value attributable to the existence of the monopoly which is the occasion for the regulation may therefore be omitted from consideration.

This is familiar legal principle. This Court has consistently recognized that a legitimate basis of rate regulation is the existence of monopoly and the need of providing a substitute for competition as a means of preventing excessive earnings. *Munn* v. *Illinois*, 94 U. S. 113; Stone, J., dissenting in *Ribnik* v. *McBride*, 277 U. S. 350, 359–360. On principle, therefore, the legislature may lawfully reduce rates, and hence earning power, to the level which, in theory, would prevail under conditions of free competition. See Whitten, *Fair Value for Rate Purposes*, 27 Harv. L. Rev. 419, 421–423; Richberg, *A Permanent Basis for Rate Regulation*, 31 Yale L. J. 263, 267. Indeed, the theoretical justification of reproduction cost as a measure of value in rate proceedings is that it is deemed to provide a measure of reasonable charges under conditions of competition. See Bauer and Gold, *Public Utility Valuation*, pp. 397–399; Richberg, *op. cit. supra*, at 267; Whitten, *op. cit. supra*, at 423.

The second fundamental premise—that any value which is based, directly or indirectly, on the earning power of the regulated company need not

be included in the rate base—is equally true and is, in large measure, a corollary of the first. The object of a rate base valuation is to fix an amount for proper measurement of reasonable rates. Since determination of such rates fixes the allowable earning power, any item which is itself based upon earning power is inappropriate as an element in the measure by which allowable earning power is determined. Under any other ruling, the dilemma is encountered that allowable earning power—i. e., the rates to be fixed—is determined upon a rate base which itself includes items based upon earning power. Since permissible earning power is thus the consequence and not the measure of reasonable rates, reasonable rates must obviously be determined by some criteria independent of earning power. See Hale, *Conflicting Judicial Criteria of Utility Rates,* 38 Col. L. Rev. 959; Bonbright, *Valuation of Property,* Vol. II, pp. 1094–1098; Bauer and Gold, *op. cit. supra,* pp. 49 *et seq.,* 141–147; Beutel, *Valuation as a Requirement of Due Process,* 43 Harv. L. Rev. 1249, 1267.

Even apart from this dilemma, however, a consideration of items based upon earning power cannot be justified. For present purposes, we need consider only earning power due to customers attached, since it is only the difference in value between an "assembled and established plant, doing business and earning money" and "one not thus advanced" which is relevant to the issue of going concern value. Cf. *Los Angeles Gas Co.* v. *Rail-*

road Commission, 289 U. S 287, 313; *Des Moines Gas Co.* v. *Des Moines*, 238 U. S. 153, 165.[16] The earning power due to customers attached is based

[16] Like enterprises may differ in earning power under conditions of free competition without apparent regard to relative costs of reproduction, due to differences in the efficiency of management, the market demand, or the relative adaptability of the property to the purpose for which it is employed. This may have been the thought underlying the suggestion of Mr. Justice Butler in *Denver Stock Yard Co.* v. *United States*, 304 U. S. 470, 479–480, as to the basis for determining going concern value. But the efficiency of management is not a factor to be considered in determining value in exchange and must therefore be excluded from consideration in fixing the rate basis on a present value basis. *The Minnesota Rate Cases*, 230 U. S. 352, 458. The special earning power due to public demand must, for the reasons suggested in the text, likewise be excluded in the case of a monopoly. *Clark's Ferry Co.* v. *Commission*, 291 U. S. 227, 238. And while it has been said that the element of value due to special adaptability of property to a particular use must be considered (*Clark's Ferry Co.* v. *Public Service Commission*, *loc. cit. supra*), it is difficult to see how this value can be determined without permitting the capitalization of monopoly earning power. Cf. Bauer and Gold, *op. cit*, *supra*, p. 274. Moreover, such special value must be due to the higher cost of reproducing the service due to the unavailability of equally efficient means. While cost of replacement of the service is the theoretical standard of free competition, the utilities would argue that the application of such a standard would frequently be unfair to the invester (Richberg, *op. cit. supra*, at 277–278) and, in fact, the reproduction cost considered in rate valuation proceedings is that of reproducing the same plant and not the same service. See *McCardle* v. *Indianapolis Water Co.*, 272 U. S. 400, 417–418. The problem of appraising the peculiar adaptability value of certain kinds of property, in any event, is a special problem not involved here and which does not materially affect the general question.

on (a) the present consumer demand for the service, created through efforts which may historically have involved substantial expenditures, and (b) the present goodwill, if any, based on friendly relations with consumers. We discuss below the propriety of the inclusion in a rate base, computed on an investment basis, of the historical *cost* of creating consumer demand. Our point here is that it is improper to include in a rate base the present *value* of consumer demand and goodwill—in other words, earning power due to customers attached.

Insofar as consumer demand reflects merely a present existing general demand for the service, as distinct from consumer preference for the particular utility, it is plainly not an item of present value properly includible in the rate base. In the competitive world, the value of a particular plant is not judged by the general consumer demand for the type of articles produced by that plant, even though the creation of such general consumer demand may have required the expenditure of large sums of money in the past; the demand for the type of article already exists and consequently, goodwill aside, one who desires to engage in the business would erect a new plant rather than purchase an old one at a price in excess of the value of the physical properties. Consumer demand is relevant to the value of a particular plant, therefore, only insofar as the demand is for the particular articles produced by the plant—in other words,

only insofar as the particular business has acquired goodwill.

The same principle must be applied in rate regulation. The utility, having a monopolistic position, may in practice enjoy the full benefit of the general consumer demand, but, if so, this is an advantage due to its monopolistic position and must therefore be disregarded under the first premise.

The same considerations require the exclusion of any item of present value based on goodwill. While it is not impossible for a utility to build up such friendly relations with customers that they would deal with the utility as a matter of preference (cf. Butler, J., in *McCardle* v. *Indianapolis Water Co.*, 272 U. S. 400, 413–415) the extent to which the relations between the customers and the utility are based on goodwill or necessity cannot be ascertained and it is therefore a reasonable basis for rate regulation to assume that "a consumer * * * will resort to the 'old stand,' because he cannot get [the service] anywhere else." *Willcox* v. *Consolidated Gas Co.*, 212 U. S. 19, 52; *Cedar Rapids Gas Light Co.* v. *Cedar Rapids*, 223 U. S. 655, 669; *Georgia Railway & Power Co.* v. *Railroad Commission*, 262 U. S. 625, 632. It is presumably in this view that this Court has stated that goodwill cannot be considered because it is due to a condition of monopoly. *Cedar Rapids Gas Light Co.* v. *Cedar Rapids, supra; Willcox* v. *Consolidated Gas Co., supra; Los Angeles Gas Co.* v. *Railrad Commission*, 289 U. S. 287, 313.

(b) Acceptance of these premises leads to the conclusion that the Constitution does not require going concern value to be included in a rate base under any permissible theory of valuation. The contrary view is based upon a confusion of the present value and investment principles of rate regulation.

One concept of going concern value—and a concept which the companies urge in some parts of their brief (Br. pp. 89–91)—is that it is the separate and additional value above the appraised property which is due to the fact that there is an assembled business, successfully conducted. Under this concept, going concern value is a value added to the value of the physical properties by reason of the fact that there are customers attached and existent earnings. Plainly, going concern value so conceived is based on general demand or goodwill, neither of which may be considered an element of present fair value in the regulation of a monopoly. Moreover, such going concern value is based directly upon earning power and, under the principles we have discussed, must therefore be excluded from value for rate making purposes.

A second concept of going concern value—and this concept, too, the companies urge in their brief (Br., pp. 81–82)—is that it represents, not the mere fact that the utility is a going concern, but the underlying fact that outlays or capital costs were incurred to reach the state of a going concern. In this view, going concern value is simply the devel-

opmental cost to bring the business to the state of a going concern.

So conceived, going concern value—or, more properly, going concern *cost*—is obviously not a proper item in a "present fair value" rate base, for such a rate base seeks to establish value without necessary regard to historical cost. And if it be urged that the historical development cost is simply a measure of the present value of what was obtained by the expenditure—namely, consumer demand, goodwill, and the resulting present earnings—the answer is, as we have already stated, that these items may not properly be considered in determining present value.

Furthermore, the underlying assumption of the reproduction cost theory, which is usually advanced by the utilities as the proper measure of present value, is that the existing demand for service continues and that the existing properties and organization are necessary to provide the service without interruption. Unless there were the actual and continuous demand for service there would be no need of the properties and no justification in assuming their reconstruction. The very valuation of the properties, therefore, presupposes the existence and continuance of the present demand without requiring a developmental period. Moreover, it assumes that the actual operating organization is immediately available, for otherwise the provision of the plant in full completeness at the valuation date would be unreasonable. Since the

existing demand and the ability to supply the demand through suitable organization are already predicated when the physical elements are assumed to be reproduced, there remains no need for further assumed expenditures to develop such demand and full efficiency to supply it.

(c) If the "investment" rather than the "present fair value" test is used, there can, of course, be no allowance for going concern value, considered simply as the amount of the total value of a going concern over and above the physical and intangible properties; this is a *value* concept which has no place in a rate base measured by and limited to actual cost.

The same is not necessarily true, however, of going concern cost considered as the development cost necessary to bring the business to the state of a going concern. Where the development cost consists of operating or capital charges which have been returned to the utility through earnings, they may not be charged again to the consumer by inclusion in the rate base. To say that additional development costs incurred after the utility has begun to earn a fair return must be treated as an investment on which a return must be paid is to say that the Constitution guarantees the utility not only its fair but its maximum earning power. Where, however, the utility fails to obtain a reasonable return during the development period, any necessary developmental costs, to the extent that they are represented by actual deficits

in earnings, may theoretically be considered as a legitimate expense which a utility should have a reasonable opportunity to recoup.

But—and this is the point which we wish to stress—the Constitution does not require that such development cost be treated as part of the investment. All that the Constitution requires, we believe, is that the investors be allowed a return sufficient to give them a fair opportunity to recoup these costs. It might be argued that this should be done by including the costs in the rate base as part of investment. Sound business and accounting practice, however, forcibly suggest that the proper method is to fix the rate of return at such a figure as to take account of the risk of loss in the development period. The risk of loss in the early years is, as Mr. Justice Brandeis observed in the *Galveston* case, "a reason for allowing a liberal return on the money invested in the enterprise," 258 U. S. at 395. If the rates imposed by regulation from the outset of the business allow a rate of return based on the risk of early loss, the inclusion of such deficits in the investment would obviously permit a double return. Lewis, *Going Value,* 26 Mich. L. Rev. 713, 729.

The soundness of considering the risk of early deficits in the rate of return and not as part of the rate base is particularly clear in view of the accounting practice to consider these outlays in the early years as operating expenses and not as

part of the investment. Lewis, *op. cit. supra,* at 723. Moreover, it is difficult if not impossible to determine the extent to which the losses were due to bad management, inefficiency, improper rates, the improvidence of the investment or the inevitable expenses of initial difficulties, a consideration which forcibly argues that the risk of early losses should be taken into account in determining the rate of return rather than by including such losses in the investment. See Lewis, *op. cit. supra,* at 727–728.

Where, as here, the development period occurred prior to the commencement of rate regulation, the consideration of past losses under the "investment" test must vary according to the circumstances. If, as we have suggested, a rate regulation imposed at the outset is valid so long as it permits the investors a reasonable opportunity to recoup losses, a rate imposed after the development period may ignore past losses so long as the investors had a reasonable opportunity to amortize the amount of such losses prior to the commencement of regulation.[17] *Kings County Lighting Company* v. *Willcox,* 210 N. Y. 479, 484–494; cf.

[17] In Wisconsin, where the past deficit rule was originally developed, it has been consistently ruled that a utility which has amortized its early losses (on the assumption of reasonable rates prior to the beginning of regulation) is not entitled to include past deficits as investment. Numerous decisions of the Wisconsin Public Service Commission are cited in 11 Minn. L. Rev. 642, 650n.

Des Moines Gas Co. v. *Des Moines,* 238 U. S. 153, 165–166; *Lincoln Gas & Elec. Co.* v. *Lincoln,* 250 U. S. 256, 267.[18]

In any event, on the most liberal application of the investment principle, the companies in this case have no basis for complaint. The total book cost of their existing properties, including gas reserves,

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[18] We are not concerned here with the question whether, if the earnings under unregulated rates had been sufficient to return part or all of the actual investment, as distinguished from operating deficits, the rates could be reduced to a level sufficient to yield a return only on so much of the investment as had not been paid back out of earnings. It may be assumed for purposes of argument that a regulatory body cannot retrospectively reduce past excessive profits by reducing present rates. Cf. *Newton* v. *Consolidated Gas Co.*, 258 U. S. 165, 175; *Board of Public Utility Commissioners* v. *New York Tel. Co.*, 271 U. S. 23, 31. It obviously does not follow, however, that development costs incurred prior to regulation must be treated as part of the present investment. The question, when investment is the basis of regulation, is whether the early losses should have been or may be deemed to have been recouped by the companies during the entire period prior to regulation, judged by the utility's own practice or that of like businesses during this period (see *infra*, pp. 90–94). If, under the company's own practice or accepted business usage, early losses may reasonably be regarded as entirely charged as a current operating expense in the years incurred, or if they may be treated as amortized by surplus earnings in the succeeding years and hence as not part of the investment, a rate which does not take into consideration any past losses so returned cannot be deemed to work an impairment of the present investment. A difficulty would arise only if rate regulation began immediately after the years of early losses, but this situation is too remote from the facts of the present case to warrant any discussion even on principle.

as of December 21, 1939, was $60,950,000.[19] There is thus a difference of approximately $13,500,000 between the companies' present investment and the rate base of $74,420,424 (R. 3937) adopted by the Commission. This amount is more than ample to allow for the $8,500,000 of "development costs" which the companies claim to have incurred. Furthermore, as we have shown (*supra*, pp. 43–44), the companies' earnings during the period from 1936 to 1938, inclusive, were more than sufficient to amortize the entire $8,500,000 and still give the companies an average return of 7.28% on their undepreciated investment.

B. The Commission Made a Proper Allowance for Amortization

The Commission allowed $1,557,852 (R. 3941) as an annual charge for amortization or depreciation. The companies claim that the amount allowed should have been $5,100,732 (R. 4040). The Commission based its allowance on the companies' claimed actual investment, without deduction of

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[19] The figures for June 1, 1939, given in the companies' brief (Br., pp. 71–72) simply ignore the retirements of $6,526,160 charged to operating expenses (R. 2993, 3007). The figure of $49,830,479 for capital expenditures is calculated by deducting the figure of $9,367,363 for "Leaseholds" in column 8 of Exhibit 137, p. 2 (R. 2993) from the figure for "Total Plant and Equipment," $59,197,842. In adding to this the figure of $15,893,513, the accumulated expenditures for gas reserves as of Dec. 31, 1938 (Ex. 138, p. 2, R. 3007), however, the companies ignore the retirements of $6,526,160, representing the difference between the two figures for gas reserves. This amount, having been charged to operating expenses, has already been returned to the companies.

retirements already made, of $67,173,761 through the years 1932 to 1938, inclusive, as taken from their book records, and estimated future capital additions, including replacements, through the year 1954 of $12,159,380, a total of $79,333,141 (R. 3023), less the estimated salvage value of the property at the assumed end of the project in 1954, $1,049,132 (R. 3025), a net total of $78,284,009 investment to be amortized. The annual allowance of $1,557,852 is the sum which, together with 6½ percent interest compounded annually, will equal at the end of 1954 the sum of $78,284,009 (see App. B., p. 139, *infra*).

The companies contend that the rate base and amortization base should both be determined on present value, which they define as reproduction cost less observed depreciation, plus working capital and a separate allowance of $8,500,000 for going concern value, plus average capital additions until 1954 (Br. p. 6). The rate base and amortization base are not entirely the same on this theory, however, since the companies' position is that, for purposes of amortization allowance, the total estimated future capital additions of $9,145,083, exclusive of replacements, must be added and salvage value of $1,049,132 be deducted, giving a total of $84,341,218 (Br. p. 8). The companies further argue that the proper rate of interest for sinking fund purposes is 2 percent compounded semi-annually (Br. p. 10), and that the period for amortization should be limited to the years following the

enactment of the Natural Gas Act or the entry of the rate order in controversy. The figure of $5,100,732 which the companies urge as the proper amortization allowance is presumably the annual allowance which, together with interest compounded semi-annually at 2 percent during this period, will yield $84,341,218.

It is apparent, therefore, that the points of difference between the companies and the Commission are these: (1) The Commission used investment as the amount to be amortized; the companies urge that it should have amortized the present fair value of the properties; (2) the Commission fixed the entire life of the enterprise as the period of amortization; the companies urge that the period of amortization should commence either as of the date of the passage of the Natural Gas Act or as of the date of the entry of the rate order; (3) the Commission computed the amortization allowance on the basis of a 6½ percent interest rate; the companies urge that it should have used a 2% interest rate. On each of these points, we believe that the Commission's action was clearly valid.

1. *The Commission properly provided for amortization of only the investment in the property*

Under the theory which we urge below (Point VI, pp. 112–133, *infra*), that it is only the investment and not the fair value of a utility's property which the Constitution protects—in other words, that the doctrine of *Smyth* v. *Ames*, 169 U. S. 466, is

wrong—there can be no possible doubt as to the validity of the Commission's action in using investment as the amount to be amortized. Our argument at this point is that its action is correct even on the view that *Smyth* v. *Ames* correctly states the applicable constitutional principle with respect to the rate base.

The rule of *Smyth* v. *Ames* is based, as the companies assert, on the view that a rate order is a taking of the use of private property for public use for which just compensation must be paid. See *West* v. *Chesapeake & Potomac Tel. Co.*, 295 U. S. 662, 671. We undertake to challenge the validity of this view in Point VI. Even under the rule of *Smyth* v. *Ames*, however, the utility is only entitled to a "fair return on the reasonable value of the property at the time it is being used for the public." *Los Angeles Gas Co.* v. *Railroad Commission*, 289 U. S. 287, 305; *Railroad Commission* v. *Pacific Gas Co.*, 302 U. S. 388, 394–395.[20] The computation of rate of return, or net earnings, however, is directly related to the basis on which operating expense for depreciation is fixed. Cf. Brandeis, J., dissenting in *United Railways* v. *West*, 280 U. S. 234, 256. The most that the rule of *Smyth* v. *Ames* can be deemed to require, therefore, is that the rate of return on

[20] A supposed justification of the rule of *Smyth* v. *Ames* as applied to the determination of the rate base is that it allows utilities the same benefit of the appreciation of property values as the owners of unregulated enterprises enjoy. See the supplement to this brief, p. 76.

fair value be determined with due regard to the basis adopted in fixing the amount to be amortized. Where this is done, the basis for determining the depreciation charge may properly be based on considerations of sound business and accounting practice. To allow the utility a depreciation charge in excess of that assumed by the Commission in fixing allowable net earnings without a corresponding decrease in the adopted rate of return would permit the utility to earn an additional and unwarranted profit.

Insofar as accepted practice may be deemed controlling, there can be no doubt that the Commission's choice of original cost was correct. It is almost uniform business practice to base the depreciation charge on cost. As Mr. Justice Brandeis stated in his dissenting opinion in *United Railways* v. *West*, 280 U. S. 234, 275, this is "the rule sanctioned by the universal practice of business men and governmental departments." This statement is supported in the opinion by an impressive demonstration of authority, drawn from all relevant data; we need only add that the practice has continued unchanged. In non-utility enterprises, the practice is still to base the depreciation charge on cost,[21] and all the sys-

[21] Gilman, *Accounting Concepts of Profit*, 348–349, 493; Sanders, Hatfield, and Moore, *A Statement of Accounting Principles* (1938), 31–32, 58–59, 60–65; Saliers, *Depreciation Principles and Applications*, 63, 68–69, 110; Montgomery, *Auditing Theory and Practice* (6th ed., 1940), 480; Paton

tems of accounts established by governmental rate-making agencies, federal and state, have adopted cost as the basis of depreciation.[22] The use of original cost in determining the depreciation charge is justified, as Mr. Justice Brandeis has demonstrated, by every relevant consideration of prudent business and accounting practice.

In determining a fair rate of return for the companies the Commission gave due regard to the fact that it had adopted original cost as the basis for determining the total amount to be amortized. To adopt present value as the basis for the amortization or depreciation charge without reducing the rate of return allowed by the Commission would permit the companies to earn a double return. This is so in part because the rate of return was based, with due allowance for the difference in risk, on the earnings and yields of securities of other enterprises. The yields of such securities, however, are based on current earnings determined after deducting depreciation on the basis of original cost and not on the basis of present value. In view of the almost universal business practice of computing the depreciation charge on the basis of cost, an in-

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and Littleton, *An Introduction to Corporate Accounting Standards*, 66, 89; see also Peloubet, *Special Problems in Accounting for Capital Assets*, 61 Journal of Accountancy 185; May, *The Influence of Accounting on the Development of on Economy*, 61 Journal of Accountancy 15–16; Bell and Jones, *Auditing* (1941), 245.

[22] The systems of account referred to in note 25, pp. 80–81, *infra*, all adopt cost as the basis of depreciation.

vestor who purchases a security which is priced above par because of increased earning power cannot expect to continue to receive both a yield at the current rate and a liquidating dividend equal to the increased price of the security.

In fixing a fair rate of return for the companies on the basis of the yields on current investments, therefore, the Commission was required to guard against the allowance of the excessive return which would result if it deducted as an operating expense a larger amount for depreciation than that charged in fixing the allowance on current investments. Moreover, in fixing the rate of return, the Commission considered the fact that in computing allowable net earnings it had determined the operating expense for depreciation on the basis of cost and concluded that a 6½ percent return as so computed would be sufficient to finance the full amount of the present value of the properties included in the rate base.

In this view, the Commission's choice of original cost as the basis of amortization satisfies any possible requirement of the rule of *Smyth* v. *Ames*. The record contains and the Commission considered extensive evidence as to the yields of other securities and the earnings of the businesses on which the yields were based (R. 3939; Ex. 185–186, R. 3576–3739; cf. Exs. 147–152, R. 3071-3303). It is clear from both the evidence and the general business practice that these earnings were computed after a depreciation charge based

on cost and that the yields on the securities whenever acquired represented earnings computed on the same basis. On the basis of this evidence, as well as other evidence as to comparative risks, the Commission concluded that on a sound basis of 40 percent bonds, 40 percent common stock, and 20 percent preferred stock, the entire amount of the fair value rate base, i. e., $74,420,424 (R. 3937), could be financed with earnings of 6.2 percent to 6.5 percent (R. 3939–3940). In so concluding the Commission expressly took into account that the depreciation expense to be deducted in determining net earnings was based on cost. In rejecting the companies' claim that depreciation should be based on fair value, the Commission declared: "The amounts of amortization are recognized and treated as operating expenses. Operating expenses are stated on the basis of cost. * * * We refuse to make an allowance of amortization in excess of cost. To do so would not be the computation of a proper expense, but instead the allowance of additional profit over and above a fair return. Manifestly such an additional return would unjustly penalize consumers" (R. 3938). In fixing the rate of return the Commission thus gave due regard both to the basis on which it had fixed the amount to be amortized in this case and also to the basis generally accepted in fixing a depreciation charge as reflected in the yields which it considered in determining the rate of return.

The universal business practice to base depreciation on cost is relevant for another reason, too. We are dealing here with the constitutional guarantee of due process; in its application to the present case, that guarantee, as we show below in discussing the underlying principle of *Smyth* v. *Ames,* means simply that there will be no arbitrary governmental interference with property rights. To limit a utility to a depreciation charge which is the same as that universally made by all business men, even though they are completely free of regulation, cannot in any realistic sense be characterized as arbitrary governmental action. To the precise contrary it would be the commission which blinded itself to the practical experience of business men and which thereby saddled upon consumers a charge having no basis in business realities which would be guilty of arbitrary conduct.

United Railways v. *West,* 280 U. S. 234, 253, is, we admit, opposed to our position. The case is distinguishable, however, on the narrow ground that the Court was there dealing with the depreciation of a utility with an indefinite life and which was therefore faced with the necessity of replacing physical properties the service life of which was exhausted; the rationale of the decision that depreciation should be based on fair value rather than original cost was that the former more accurately measured replacement cost than the lat-

ter. Here, on the other hand, we have a utility with a limited life expectancy and with physical properties that will, in the main, outlast its gas reserves; there is, therefore, no real problem of replacement at all.[23]

This distinction, however, is not a satisfactory disposition of the matter because, for the reasons we have advanced, the *West* case is wrong on principle. It is opposed to the statement of this Court in *United States* v. *Ludey,* 274 U. S. 295, 300–301, a federal income tax case, where the Court said: "The amount of the allowance for depreciation is the sum which should be set aside for the taxable year, in order that, at the end of the useful life of the plant in the business, the aggregate of the sums set aside will (with the salvage value) suffice to provide an amount equal to the original cost." And it is opposed to the statement of this Court in *Lindheimer* v. *Illinois Bell Tel. Co.,* 292 U. S. 151, 167, that "In determining reasonable rates for supplying public service, it is proper to include in the operating expenses, that is, in the cost of producing the service, *an allowance for consumption of capital in order*

[23] Moreover, we submit that present value has no predictable relation to future replacement cost (see Brandeis, J., dissenting in *United Railways* v. *West*, 280 U. S. 234, at 278), and is certainly no more reliable a test for this purpose than is original cost. See Stone, J., dissenting in *United Railways* v. *West*, 280 U. S. at 289–291.

to maintain the integrity of the investment in the service rendered." [Italics supplied.] See also *Knoxville* v. *Knoxville Water Co.*, 212 U. S. 1, 13, 14. Mr. Justice Butler, in his concurring opinion in the *Lindheimer* case, stated that the method of depreciation approved by the majority was not in harmony with the principle of the *West* case, 292 U. S. at 176. And the Virginia Supreme Court of Appeals, in *Alexandria Water Company* v. *City Council of Alexandria*, 163 Va. 512, stated that the *West* case was, in its view, at least inferentially overruled by the *Lindheimer* case. It is significant, too, that despite the *West* case, the federal and state utility commissions, almost without exception, have continued to follow cost accounting for depreciation.[24]

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[24] *Re Telephone and Railroad Depreciation Charges*, 177 I. C. C. 351; *Re North West Tel. Co.* (Wis.), P. U. R. 1931A, 53, 56–7; *Re Long Branch Sewer Co.* (N. J.), P. U. R. 1931A, 467, 473; *Re Patrons of Lakeville Water Co.* (Conn.), P. U. R. 1932D, 138; *Re Yonkers Railroad Co.* (N. Y.), P. U. R. 1933B, 61, 84; *Re Mondovi Tel. Co.* (Wis.) P. U. R. 1933B, 319, 330; *Re Mondovi Tel. Co.* (Wis.), P. U. R. 1933D, 142; *Re Lincoln Tel. & Tel. Co.* (Neb. 1935), 6 P. U. R. (N. S.), 81, 90; *Alexandria Water Co.* v. *City Council of Alexandria* (Va. 1935), 7 P. U. R. (N. S.), 53, 113; *Re Yonkers Railroad Co.* (N. Y. 1935), 9 P. U. R. (N. S.), 337, 365; *Re Wisconsin Tel. Co.* (Wis. 1936), 13 P. U. R. (N. S.), 224, 251; *Re Peoples Gas Light & Coke Co.* (Ill. 1937), 19 P. U. R. (N. S.), 177, 257; *Re Northern States Power Co.* (N. D. 1938), 22 P. U. R. (N. S.), 364, 370; *Pacific Tel. & Tel. Co.* v. *Wallace* (Ore. 1938), 23 P. U. R. (N. S.),

In the light of all these considerations, this Court should now, we submit, expressly overrule the *West* decision and hold that, even under the rule of *Smyth* v. *Ames,* rates which provide for a full return of the original investment plus a fair return on the present fair value of the property included in the rate base, satisfy all constitutional requirements.

2. *The Commission properly fixed the amortization period as the entire life of the enterprise*

It has been shown that the charge for depreciation must be based upon cost. The next question is as to the amount of the total cost the companies are entitled to charge for depreciation in the fu-

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65, 86; *Re Northern Power & Light Co.* (N. D. 1939), 30 P. U. R. (N. S.), 1, 5; *Re North Dakota Power & Light Co.* (N. D. 1940), 31 P. U. R. (N. S.), 26, 29; *Re Alabama Water Service Co.* (Ala. 1940), 32 P. U. R. (N. S.) 129; *City of Los Angeles* v. *Nevada-California Electric Corp.* (Fed. Power Comm. 1940), 32 P. U. R. (N. S.), 193, 204; *Re Otter Tail Power Co.* (N. D. 1940), 33 P. U. R. (N. S.), 301, 306; *Re Swan Creek Electric Co.* (Utah 1940), 35 P. U. R. (N. S.), 315, 316; *Re Central Light & Power Co.* (N. D. 1941), 37 P. U. R. (N. S.), 106, 111. The *West* case, wherever considered by the commissions in these cases, was criticised as unsound. Economists and accountants have likewise insisted that cost is the only proper basis of utility depreciation accounting. Mosher and Crawford, *Public Utility Regulation* (1933), 160–162; Jones and Bigham, *Principles of Public Utilities* (1937 ed.), 491 *et seq.;* Wilson, Herring and Eutsler, *Public Utility Regulation* (1938), 196 *et seq.;* see also Haun, *Inconsistencies in Public Utility Depreciation,* 38 Mich. L. Rev. 160, 479.

ture. The answer to this question depends upon the nature of depreciation and the proper method of accounting for it.

The Commission's conclusion th amortization should be regarded as an "operating expense" based on "cost" (R. 3937) reflects the view, now accepted by almost all informed opinion, that depreciation is the diminution of the service capacity of the property or, in terms of the monetary measure of the original service capacity, the diminution in service value. See *Proceedings of the National Association of Railroad and Utilities Commissioners,* 1938, pp. 441–443; *Telephone and Railroad Depreciation Charges,* 177 I. C. C. 351, 372–382. This is the uniform conclusion of all rate-making agencies, both federal and state.[25] This, too, is the view

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[25] The Uniform System of Accounts for Natural Gas Companies promulgated by the Federal Power Commission, effective January 1, 1937, defines depreciation as "the loss in service value not restored by current maintenance, incurred in connection with the consumption or prospective retirement of gas plant in the course of service from causes which are known to be in current operation and against which the utility is not protected by insurance. Among the causes to be given consideration are wear and tear, decay, action of the elements, inadequacy, obsolescence, changes in the art, changes in demand and requirements of public authorities, and, in the case of natural gas companies, the exhaustion of natural resources." Service value is defined as "the difference between original cost and net salvage value." See also Uniform System of Accounts for Class A and Class B Telephone Companies promulgated by Federal Communications Commission, effective January 1, 1937; Uniform System of Accounts for Electric Utilities promul-

expressed by this Court in *Lindheimer* v. *Illinois Bell Tel. Co.*, 292 U. S. 151, 167. This view of depreciation is based on the simple principle that the economic value of property—its ability to earn a return—consists of the total units of useful service which it is capable of producing. Paton and Littleton, *Introduction to Corporate Accounting Standards*, p. 84; Porter and Fiske, *Accounting*, p. 406; Taussig, *Principles of Economics*, Vol. I, p. 70; *Proceedings, supra*, pp. 444-445; *Telephone and Railroad Depreciation Charges, loc. cit. supra.*

The annual depreciation is thus the amount of the service capacity which has been consumed in any one year. The service capacity used up in any one year is a cost of operation just as much as fuel or any other property which is totally con-

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gated by the Federal Power Commission, effective January 1, 1937; Uniform System of Accounts for Electric Utilities recommended by the National Association of Railroad and Utilities Commissioners (1936); Uniform System of Accounts for Natural Gas Companies recommended by the National Association of Railroad and Utilities Commissioners. Twenty-seven states have adopted the Federal Communications Commission system for Class A and Class B telephone companies identically; eight have adopted it substantially; no system is prescribed in the other states. See Federal Communications Commission Release, August 18, 1941, Accounting Systems Prescribed by the States for Use of Telephone Companies. Similar systems have been adopted by the majority of states for electric and gas utilities. See *State Commission Jurisdiction and Regulation of Electric and Gas Utilities*, published by the Federal Power Commission, January 1941, pp. 11, 35.

sumed, physically and economically, during the year. As this Court observed in *Illinois Central Railroad* v. *Interstate Commerce Commission*, 206 U. S. 441, 462, "It would seem as if expenditures for additions to construction and equipment, as expenditures for original construction and equipment, should be reimbursed by all of the traffic they accommodate during the period of their duration * * *." It is for this reason that in fixing reasonable rates there should be included in "operating expenses, that is, in the cost of producing the service, an allowance for consumption of capital * * *." *Lindheimer* v. *Illinois Bell Tel. Co.*, 292 U. S. 151, 167. As stated by the companies' witness Cooke, "Depreciation reserve is a charge made to operations over a given period of time, which is intended to recover the amount invested in the fixed asset which is used up or worn out in that time; in other words, to recover the capital investment within the useful life of the property" (R. 2620):

In this case, eight and a half years elapsed between the time of the beginning of business by the companies and the effective date of the rate order and in that time a considerable part of the service life of the plant assets was used up. Consequently, it would be contrary to fact to make the assumption that no part of the service life of the assets should be charged to the prior period.

The companies concede this in principle; they admit that the physical or "viewed" depreciation must be deducted (Br. p. 8) although they ignore the controlling factor of functional depreciation due to the exhaustion of the gas supply. The real question in the case, therefore, is not what period of amortization should be used, but what amount should be considered as charged for depreciation for the period prior to the rate order.

The Commission has in effect concluded that, of the total cost to be amortized, the sum of $13,317,921 should be considered as charged for depreciation during the seven-year period ending December 31, 1938 (see App. B, p. 139, *infra*), a date which is taken merely for purpose of convenience in making comparison with the record evidence as to the companies' past practice. The companies contend that the accrued depreciation is only $2,485,079 for the same period (Ex. 141, R. 3025). The Commission's conclusion is, we submit, amply sustained by the record, both on the "fair value" and "investment" theories of rate regulation. Cf. *Clark's Ferry Co.* v. *Public Service Commission,* 291 U. S. 227, 240; *Georgia Railway & Power Co.* v. *Railroad Commission,* 262 U. S. 625, 633; *Peoples Gas Light & Coke Co.* v. *Slattery,* 373 Ill. 31.

(a) On the theory of *Smyth* v. *Ames* that it is the property and not the investment which the Constitution protects, the actual past depreciation of the property must be deducted in order to deter-

mine what property must be returned to the companies in the future. *Knoxville* v. *Knoxville Water Co.*, 212 U. S. 1, 13–14; *Minnesota Rate Cases*, 230 U. S. 352, 456–458; *Lindheimer* v. *Illinois Bell Tel. Co.*, 292 U. S. 151, 157, 167.[26] We have shown that the actual past depreciation is the diminution of service capacity that has occurred.

The diminution of service capacity may best be measured in units of time elapsed or of service rendered. See *Proceedings of the National Association of Railroad and Utilities Commissioners*, 1938 pp. 441–443; *Telegraph and Railroad Depreciation Charges*, 177 I. C. C. 351, 402.[27] And ample data for the reasonable application of either measure is contained in the record. There is voluminous evidence, based on actual experience and observed conditions at the time of the proceedings (cf. *Lindheimer* v. *Illinois Bell Tel. Co.* 292 U. S. 151, 169–170; *McCardle* v. *Indianapolis Co.*, 272 U. S. 400,

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[26] On this theory, business and accounting practice in making provision for the cost of operation represented by the consumption of service life is immaterial. If past charges for depreciation have been excessive, the utility may retain the benefit. *Board of Public Utility Commissioners* v. *New York Tel. Co.*, 271 U. S. 23. If past charges have been inadequate, the utilities must bear the loss. *Knoxville* v. *Knoxville Water Co.*, 212 U. S. 1, 13–14.

[27] The units of service or production method is impractical in the case of many utilities and depreciation expense in such cases is therefore usually measured on a time basis. *Telegraph and Railroad Depreciation Charges*, 177 I. C. C. 351, 403.

416), as to the actual past withdrawals of gas and probable future withdrawals on which the service life of the properties depend (R. 629–646), the physical condition of the properties (R. 1286–1309), the actual rate of their use in the past (R. 206–211) and estimates of future use based on "the controlling test of experience". *Lindheimer* v. *Illinois Bell Tel. Co., supra,* at 170.

The total service life of the depreciable property is limited, as the companies' witnesses testified, by the supply of gas. The companies' witnesses have estimated that the gas supply in the field on which they depend will be exhausted at the end of the year 1954, and that on that date, therefore, the properties now in service must be retired (R. 3936).[28] The companies' evidence shows that physical wear and tear has been a relatively negligible factor (see *infra,* pp. 89–90) and that the withdrawals from the gas field have not and will

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[28] This estimate is based on the rate of past withdrawals by all gas companies, which is an ascertainable fact (R. 206–211) and the rate of future withdrawals, which of course can only be an approximation (R. 629–646). While the estimate may thus require revision in the light of actual experience, an estimate must be made now for the purpose of fixing rates since accrued depreciation and future depreciation expense must both be based on the total service life determined in accordance with the most reliable data now available. Cf. *Lindheimer* v. *Illinois Bell Tell. Co., supra,* at 171–172, 174.

not require curtailment of the companies' operations below the 1936–1938 average (R. 692), during which the companies operated at the load factor of 92.48% (R. 1330), as close to 100% of total utilization as is practicable in actual operations (R. 632).[29]

On these facts, it would have been reasonable to conclude that an equal amount of service capacity is lost each year. On the view most favorable to the companies, the depreciation, as the witness Kleinman testified, should be computed on the basis of the actual amount of gas withdrawn and sold by the two companies, thus excluding the physically potential service capacity which allegedly could not

[29] It is true that the withdrawals from the field in the past apparently increased slightly from year to year (R. 209) and that this tendency might continue in the future (R. 639), although the companies' witness Dickinson estimated that it would even off in 1942 (R. 645). The absence of uniformity in past or future withdrawals, however, is immaterial. The companies used the average of the years 1936–1938 in computing normal operations throughout the service life, both in their estimate of a 92% operating load factor on which to base "going concern" value (R. 1330) and in their testimony as to future revenues (R. 1401). For all practical purposes, therefore, it is reasonable to assume that the companies' properties have been and will continue to be capable of maximum use throughout the life of the gas reserve without regard to the variations in the rate of total withdrawals by all gas companies withdrawing from the same field. There was some evidence that the limitation of supply would require a reduction of output in the last two or three years (R. 762), but there was other evidence that the companies' estimate was overly conservative (R. 53–54, 1880, 1887).

be used by reason of limitations of the market demand (cf. R. 2431). The companies' evidence as to the actual rate of use of their facilities in the past (R. 1330) and the probable rate of use in the future (R. 692) provide reliable data on which to determine the total original service capacity and the percentage which has been consumed in actual operations in the past. On the basis of this evidence, the Commission would have been entitled to conclude that the loss of service capacity during the seven-year period was approximately 25 percent of the total.[30]

We have shown above that the monetary measure of depreciation is original cost. The loss of service value, therefore, is a very minimum of about

[30] This figure is arrived at as follows: The witness Emery took the operating load factor of 92.48%, the three-year average for 1936–1938 (R. 1329–1330), as the measure of normal operations in measuring the "going value" of the property, and other witnesses for the companies' computed future revenues on the same 1936–1938 basis (R. 692). Taking this average at 100, Emery calculated that the percentage of unused capacity, allowing for a change in rated capacity in the early years, was approximately 52% in 1932, 56¾% in 1933, 21½% in 1934, and 3½% in 1935, or an average of about 33⅓%. The change in rated capacity during this period was from 175,000,000 cubic feet per day to 210,000,000 cubic feet per day (R. 1330), that is, the earlier capacity was only 83⅓% of the later. Thus the average used capacity in the first four years was two-thirds of 83⅓% or 55½% of the later years. Taking the useful capacity for each of the last 19 years at 100 and the useful capacity of each of the first four years at 55½, the total capacity may be represented by

25 percent of $59,197,842.69, the cost as shown on the companies' books for the property as of December 31, 1938, or approximately $14,500,000. This is exclusive of $6,526,160 for retirement of gas leases, this sum being the difference between the original cost and the book cost for leases shown as of December 31, 1938 (R. 2993). This amount should be added since it was included by the Commission in the total sum to be amortized (R. 3938). Thus the sum to be deducted from the total amount to be amortized after December 31, 1938, is about $21,000,000, a sum substantially in excess of the amount which the Commission's method of amortization credits to depreciation reserve for these years. See *supra*, p. 83.

The validity of this conclusion is amply confirmed by the companies' own practice. The companies' books show a total of $19,558,810 for this seven-year period for depreciation, depletion, and retirements, the latter having been charged as an

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1900 plus 222, or 2122. On this basis the capacity consumed in the first seven years is 522, representing 222 for the first four years and 300 for the next three years of full capacity, or slightly less than 25% of the total.

The companies' witness Biddison recognized the propriety of determining accrued depreciation on the basis of the percentage of total service capacity consumed in past operations when he calculated the depreciation of the companies' automobiles on the basis of the relation of past mileage to total mileage life (R. 1305–1306). The same witness, however, used the inconsistent and, as we show below (see *infra*, pp. 89-90), indefensible "viewed depreciation" method in estimating the depreciation of all other property of the companies.

operating expense by direct credit to plant account rather than to the depreciation reserve (R. 2959). In the absence of persuasive evidence to the contrary, this amount may be taken as the companies' own estimate of the actual depreciation expense, including the cost of retirements, during the years in question. Cf. *New York Telephone v. Prendergast*, 36 F. (2d) 54, 66 (S. D. N. Y.). The companies' suggestion (Br. p. 120) that the amounts set up in their books for these purposes were merely bookkeeping entries is entitled to no credence. The companies' accounting practice was based on studies of service lives and made in accordance with expert advice (R. 2643–2645). The Commission did not believe, and this Court can hardly assume, that the companies, in providing for depreciation, took no account of the current exhaustion of the gas wells or that, ignoring all expert opinion, they failed to treat depreciation expense as an actual expense for the current consumption of capital. See the testimony of the companies' witness Cooke at R. 2619.

The only evidence to which the companies can point in support of a contrary conclusion is the testimony of their witness Biddison. Biddison's estimate of "viewed depreciation" as of January 1, 1939, was only $2,485,079 (Ex. 141, R. 3025). His estimate, however, was based solely on the "physical condition" of the property (R. 1284–1286, 1293–1295). It thus took no account of the controlling factor of the gradual exhaustion of

the gas reserves, a factor which was constantly in operation throughout the life of the physical properties. Biddison's method of determining accrued depreciation, which assumes that depreciation is limited to the loss of current operating efficiency and ignores the continuous consumption of the capital invested in the properties, is obviously absurd. It attributes to property which has lost a large part of its total service capacity a present value of only 4.4% less than its value new. And the companies, logically enough, have drawn the indefensible conclusion that no further depreciation will occur throughout the entire life of the properties, assuming proper maintenance (cf. Ex. 142, R. 3029–3031).

(b) On the investment theory of rate making, it is equally clear that the amount in effect allocated by the Commission to past depreciation is reasonable. Since the purpose of depreciation on an investment basis is to give the investors back their full investment at the expiration of the life of the business, the amortization of the investment may be, and under common practice always is, spread over the whole life of the property; any method of amortization of the investment over the whole life of the property is proper so long as it provides a "reasonable plan of distribution." See Brandeis, J., dissenting in *United Railways* v. *West*, 280 U. S. 234, 263–264. In other words, on the investment basis the relation between the rate of depreciation and the return of investment is a matter of

sound business accounting. See Bonbright, *Valuation of Property*, Vol. 2, pp. 1139–1140.

If rate regulation had been imposed at the outset of the business, it would clearly have been a reasonable method of distributing amortization, and indeed, the only reasonable method, to spread it over the whole life of the enterprise by granting an amortization allowance each year. This could validly have been done either on a straight line, actual consumption of service, or on a sinking fund basis which defers some of the amortization until the later years. See *Clark's Ferry Co.* v. *Public Service Commission*, 291 U. S. 227, 240–241.

Where, as here, rate regulation is directly imposed for the first time after part of the life of the enterprise has expired,[31] the same methods of

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[31] The Court should note that the business of the companies was of a public character from the day it commenced operation. Several million inhabitants of Chicago and the northern part of Illinois were immediately dependent upon it for gas service. To demonstrate the reasonableness of its contract with Chicago District Pipeline Company, the companies presented evidence of the estimated earnings of the project before the Illinois Commerce Commission in 1931 (R. 3320, *et seq.*; R. 3335, *et seq.*). Subsequently, as a result of this inquiry and the refusal of the Illinois Commerce Commission to approve Chicago District Pipeline Company's contract with the Chicago gas distributing utilities, the companies reduced their rates to the Chicago District Pipeline Company. In *Natural Gas Pipeline Co.* v. *Slattery*, 302 U. S. 300, this Court upheld the right of the Illinois Commerce Commission to have access to the companies' books and records in a new proceeding involving the reasonableness of the rates and charges of the Chicago District Pipeline Company.

amortization may validly be employed, at least so long as their use does not defeat any legitimate past expectations of the investors. In *Knoxville* v. *Knoxville Water Co.*, 212 U. S. 1, it was held that, in fixing a rate base which reflected depreciation accrued in the past, it was proper to take into consideration not only the actual consumption of the service capacity of the property in the preceding years of the utility's life, but also depreciation reserves for which the company should have made provision in discharge of its "duty to its bond and stockholders." 212 U. S. at 13–14.

It is true that in the *Knoxville* case accrued depreciation was apparently based upon fair value rather than investment. But the rationale of the decision was that it was proper to compute the rate base for the future on an assumption as to the proper depreciation reserves which the company itself should have set up in the past in pursuance of its duty to its investors. This principle is, we submit, clearly correct, since the retroactive application of a statute is constitutionally objectionable under the due process clause only where such application undermines without notice reasonable assumptions upon which those subject to the statute have acted in the past.

In this case the assumptions which the Commission made as to the amortization practice which the companies adopted or should have adopted in the past were clearly reasonable and

cannot be said to have defeated any legitimate expectations of the companies. To adopt the contrary view that the entire amortization should be attributed to the future life of the enterprise means that the Commission was constitutionally required to assume that the companies did not in fact, or should not have been expected to, make any provision for amortization of investment out of their earnings during the first eight and a half years of their life expectancy of 23 years.[32]

Stated somewhat differently, during the period prior to the rate order the companies must have earned enough to return a reasonable portion of

[32] The companies rely on two cases involving the United Fuel Gas Company (*United Fuel Gas Co.* v. *Kentucky Railroad Comm.*, 13 F. (2d) 510 (E. D. Ky.), affirmed 278 U. S. 300; *United Fuel Gas Co.* v. *W. Va. Pub. Serv. Comm.*, 14 F. (2d) 209 (S. D. W. Va.), affirmed 278 U. S. 322) to sustain their position. However, from the companies' own statement of the cases (Br. 123–127) it is obvious that these decisions, far from supporting their contention, are in accord with what the Commission did in this case. In the Kentucky case, it was specifically held that "a depletion charge, in estimating the reasonable rate, must be figured upon the investment value, and over the entire estimated life of the properties." 13 F. (2d) at 523. The court's observation that the company is entitled to receive back its entire investment, plus a reasonable return upon such investment, "during the dedication of it to public use" (13 F. (2d) at 523) obviously means during the period of operations, and, as was actually held in the case, the period before regulation may be considered. In the West Virginia case, the Commission deducted the past accrued depreciation and amortization from the present fair value, which it reluctantly used as the amortization base, and amortized the balance over the re-

their investment unless their enterprise was improvidently conceived or the management was either inefficient or imprudently failed to maintain a proper reserve "to keep the investment unimpaired." *Knoxville* v. *Knoxville Water Co., loc. cit. supra; Lindheimer* v. *Illinois Bell Telephone Co.,* 292 U. S. 151, at 169; Brandeis, J., dissenting in *United Railways* v. *West,* 280 U. S. 234, at 264. We are not urging that the companies' past earnings may now be retroactively restricted to an amount which would have been reasonable if they had always been subject to regulation; we do urge, however, that the Constitution does not guarantee the companies against any loss of their investment due to past improvidence.

As we have noted, the amount ($19,558,811.44) which the companies charged for depreciation, depletion, and retirement [33] during the years 1932 to

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maining life. P. U. R. (W. Va.) 1925B 705, 743–747. The past accrued depreciation was estimated by taking a certain percentage of earnings during the past operations, although the period did not include the entire period of past operations. It is clear, however, that the period chosen was not dependent on the absence or presence of a regulatory statute, since the company was regulated even prior to the period chosen. The District Court reduced the allowance for future amortization because it concluded that the Commission's estimate of service life was too short. 14 F. (2d) at 211. In neither case was the question of the proper period of amortization before this Court.

[33] The companies charged retirements as an operating expense and did not pay them out of depreciation reserve (R. 3904).

1938, inclusive (R. 2959) is larger than the amount of amortization of investment attributed to those years ($13,317,921) under the sinking-fund method adopted by the Commission (App. B, p. 139, *infra*). Plainly, therefore, the action of the Commission finds ample justification in the companies' own judgment as to the amount of the investment which should have been returned in the past under prudent management.

3. *The Commission used a proper rate of interest in computing the amortization allowance.*

The companies contend that the amortization allowance should have been computed on the basis of 2% interest compounded semiannually rather than on the basis of 6½% interest compounded annually and that the Commission's failure to do this invades their constitutional rights. They advance this contention to the Court in all earnestness despite the fact that they themselves, prior to actual operation but after construction had begun, planned for amortization of their investment by the use of the sinking fund method, using interest at the rate of 6% (R. 3567–3572).[34]

The companies' contention is based on the ground that it is impossible to invest a fund in

[34] In practice, however, after the companies began operation, they failed for a time to make any provision for depreciation or amortization. In 1934, as the companies' secretary explained (R. 2643–2645), this neglect was criticized

risk free securities at more than a 2% interest rate. The argument, however, misconceives the nature of the sinking fund method used by the Commission. The companies speak of the method as though it provided for an actual fund to be handed over to a trustee and invested, as in the case of the sinking funds provided for in many trust indentures to retire outstanding bonds. No such actual fund was created or contemplated by the Commission here; rather the Commission used a mathematical sinking fund formula to compute that return from the earnings of the property which would provide not only a fair return on the unamortized portion of the rate base but also a full return of the investment. The sinking fund method, as applied by the Commission in this case, is similar to the usual accounting and financial treatment of this device (R. 2096; R. 1910 *et seq.*). It is designed to permit the utility to include each year in its operating expenses a sum which, with interest compounded annually during the remaining service life of the property

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by both the Federal Trade Commission and their own privately employed auditing firm. Thereupon, the companies set up a committee to consider the problem. Studies were made, service lives of the various classes of property were estimated, and provision from then on made predicated upon book cost and apparently on a straight-line basis (R. 2645). Between the years 1932 to 1938, inclusive, the companies charged to depreciation, depletion, and retirement the sum of $19,558,811.44 (R. 2959).

at a rate identical with the adopted rate of return, will yield a sum equal to the total amount to be amortized.

In form, the sinking fund method provides for a 6½% return, plus amortization allowance, on a rate base from which no deduction for amortization has been made; in effect, by computing the amortization allowance on a 6½% basis, the formula provides the companies with (1) a 6½% return on the unamortized portion of the rate base; plus (2) the amortization allowance (i. e., the amount which, together with interest of 6½% compounded annually over the amortization period, will equal the investment in the properties); plus (3) an amount equal to 6½% on the amortization reserve.

That this is the effect of the Commission's formula can readily be demonstrated by reference to the example set forth in Exhibit 182 (R. 3553). That example assumes that there is a utility with properties worth $1,000,000, that a fair return on those properties is 8%, and that the life of the properties is 10 years. On this assumption, an annual amortization allowance of $69,029, with interest at 8% compounded annually, is required to return to the utility the full $1,000,000 value of its properties. By allowing the utility 8% upon the full $1,000,000 throughout its life, plus an annual amortization allowance of $69,029, the utility is given each year, as the exhibit shows, an

8% return on the unamortized portion of the rate base, an annual amortization allowance, and 8% on the entire amortization reserve. Over the full 10-year period, therefore, the utility will receive, by way of amortization allowance and interest on amortization reserve, the full $1,000,000 to be amortized, plus an annual 8% return on the unamortized portion of the rate base.

This will become readily apparent by taking the figures for just the first two years. In the first year the rate base is $1,000,000, the return on that rate base at 8% is $80,000, and the amortization allowance is $69,029. In the second year, the unamortized portion of the rate base is $1,000,000 less the amortization reserve of $69,029, or $930,971. Nevertheless the utility is allowed an 8% return on the full rate base of $1,000,000, or $80,000. $74,477 of this $80,000 represents an 8% return on the unamortized portion of the rate base ($930,971) and the remaining $5,523 represents an 8% return on the amortization reserve of $69,029. It is thus evident that by applying the rate of return figure to the full rate base, what the Commission in effect does is to allow that rate of return on the unamortized portion of the rate base plus interest, at the same figure as the rate of return, on the amortization reserve.

As applied to this case, the formula provides the companies out of the earnings of the enterprise, not only with a 6½% return on the unamor-

tized portion of the rate base, but also with an amortization allowance, computed on the basis of 6½% interest, and with 6½% interest on the amortization reserve. Accordingly, no question is presented as to the rate of return which could be earned by an actual fund invested in risk free securities.

It is to be noted that if a rate of interest lower than the 6½% rate of return allowed on the rate base—for example, the 2% figure suggested by the companies—were used to compute the annual amortization allowance, the utility would be receiving 6½% interest on its amortization reserve, even though the amount of the annual amortization allowance was computed on the assumption that only 2% was to be earned. The excess of 4½% interest on the amortization reserve over that which is necessary to return the entire investment is, in substance, an added return on the unamortized portion of the rate base over the 6½% return found to be fair and reasonable. The example in Table II of Exhibit 182 (R. 3555) shows that, in the case of the assumed $1,000,000 enterprise which has a life expectancy of 10 years and which is allowed an 8% return on rate base, the effect of computing the amortization allowance at 2% rather than at 8% is to allow the company an average return on the unamortized portion of the rate base, not of 8%, but of 12.59%.

The only possible objection to the method which the Commission used is that it requires investors to look for their interest on the amortization reserve to the earnings of the business and therefore involves some risk to them. If a straight line method of depreciation had been used, or if an actual sinking fund had been set up allowing the investment of the amortization allowance in risk free securities at 2%, this risk of amortization would not be present. But, if either of these methods had been used, the average annual amortization allowance would have been greater, the unamortized portion of the rate base would have been correspondingly smaller, and, accordingly, the 6½% return on the unamortized portion of the rate base would have been smaller. The larger return on rate base allowed under the Commission's method is a precise measure of reward for the additional risk arising out of the fact that the companies must look to the earnings of a 6½% business rather than to those of a 2% business for their amortization, for the additional return is exactly proportionate to the difference between the interest rate of the supposed riskless investment and the larger rate of return allowed on the companies' business by reason of its supposed risk. If the rate of return is properly determined, the difference in reward will correspond exactly with the difference in return which an investor would ask for taking the additional risk.

C. The Commission Provided a Proper Rate of Return

The Commission found "that 6½ percent is a fair annual rate of return upon the rate base allowed" (R. 3940, 3945). Under Section 19 (b) of the Act that finding is conclusive if it is supported by substantial evidence. The court below held that there was substantial evidence in the record to support the finding and its decision in this respect is plainly correct.

In *Bluefield Co. v. Public Service Comm.*, 262 U. S. 679, 692–693, this Court pointed out the elements to be considered in determining a fair rate of return:

> * * * A public utility is entitled to such rates as will permit it to earn a return on the value of the property which it employs for the convenience of the public equal to that generally being made at the same time and in the same general part of the country on investments in other business undertakings which are attended by corresponding risks and uncertainties; but it has no constitutional rights to profits such as are realized or anticipated in highly profitable enterprises or speculative ventures. The return should be reasonably sufficient to assure confidence in the financial soundness of the utility and should be adequate, under efficient and economical management, to maintain and support its credit and to enable it to raise the money necessary for the proper discharge of its public duties. A

> rate of return may be reasonable at one time and become too high or too low by changes affecting opportunities for investment, the money market and business conditions generally.

See also *Willcox* v. *Consolidated Gas Co.*, 212 U. S. 19, 48–50; *Lincoln Gas & Elec. Co.* v. *Lincoln*, 250 U. S. 256, 268.

Under this test, the 6½% rate which the Commission allowed was clearly reasonable. The evidence shows that profits earned by industrial corporations declined from 11.3 percent on invested capital in 1929 to 5.1 percent in 1938; for utility corporations, profits declined from 7.2 percent to 5.1 percent during the same period; and for railroad corporations the decline was from 6.4 percent to 2.3 percent (Ex. 185, Schedule 17, R. 3697, 3699). Interest rates were at a low level on all forms of long and short term investments and the rates of return demanded by investors were among the lowest that ever existed (Ex. 180, R. 3523; Ex. 185, schedules 1 to 5, R. 3581, *et seq.*). Specifically, securities of natural gas companies were being sold at rates of from 3 to 6 percent with the yields on the bulk of the bond issues falling between 3 and 4 percent. Banks were making large loans at interest rates of from 2 to 3.25 percent in most cases (Ex. 181, R. 3525–3552; Ex. 186, schedules 6, 7; R. 3777, 3779). The Commission was certainly warranted in concluding upon these facts that 6½% was a generous return unless the enterprise was subject to

extraordinary risks. Indeed, the companies scarcely urge the contrary.

There was also abundant evidence showing not only that the companies faced no extraordinary risks but that even less risk of loss of capital investment attended the enterprise than the risk to which the ordinary utility is subject.

First, the companies have unusual assurances of an outlet for their product. Metropolitan Chicago is a growing industrial area and forms a thoroughly desirable market. The companies in effect have both a legal and a practical monopoly of the territory, for although they do not service the community directly, the utilities which do service it own 26 percent of the investment in the pipeline company and are really partners in the enterprise (R. 1945). Consequently there is no danger of competition from a new source of supply (R. 2543–2544), while the advantages of gas for many uses offset to a large extent the possibility of losses to competing fuels (R. 3440, 3456, 3485).

Decisive on this point, however, is the fact that 90% of the companies' capacity is taken under the contract with the Chicago District Pipeline Company, which contract is to run until 1946, or until 1951, at the option of the companies (R. 3). Chicago District is bound to take, or at least pay for, over 66⅔%. The contract is guaranteed by the three distributing utilities in Chicago. Few companies can show such complete protection against the risk of losing the market.

Second, the fact that the companies are engaged in an extraction industry is not a risk which is to be reflected in the rate of return. In estimating the life of the natural gas field in order to calculate the amortization period, the dangers of early exhaustion have been taken into account as well as the possibility that the enterprise will live longer than the estimated period. A second allowance for those factors of risk should not be made in the rate of return. To the contrary, the fact that the entire investment is to be amortized over a relatively short period gives the companies security lacking in most industries where capital investments are relatively permanent.

Third, the companies' corporate affiliations make their financial future relatively secure. The resources of the six large corporations which directly or indirectly own all of the stock (p. 9, *supra*) provide assurance that the companies can readily obtain any future capital requirements. Compare *Wabash Valley Electric Co.* v. *Young*, 287 U. S. 488, 501.

Fourth, while the companies stand in the same position as any other corporation in respect to many miscellaneous lesser risks—increased taxes, costs of regulation, inflation, costs of operation, mechanical failures and so forth—the evidence shows that they are more favorably situated in respect to others. The problem of converting inventory into cash is not as great (R. 2082–2084); the labor factor is not as great (R. 2084); credit

risks scarcely exist (R. 2084–2086); and risks arising out of varying demands for a product and because of technological changes are small (R. 2086–2088).

The foregoing proof plainly warranted the Commission in concluding that the companies faced no extraordinary dangers of capital losses which should be compensated by extra returns and that they had, on the contrary, a relatively secure investment. There was also evidence that before the enterprise was under way the companies themselves estimated that their return would be approximately 6.3 percent before federal income taxes (Exs. 156, 157, R. 3334, 3368). Their willingness to make the investment for that return is complete proof that 6.5 percent after taxes is a generous return after the business had been put on a stable basis.[35]

The current level of interest rates, the record of recent natural gas financing, the relative security

[35] Exhibit 136, page 1 (R. 2959), reveals that for the five years preceding the hearing the companies enjoyed stable and growing revenues. The companies' own figures show that net earnings before interest, amortization of bond discount and expense, depreciation, depletion and retirements, and net profit after such charges, as fixed by the companies, were:

Year	Net earnings before other charges	Net profit after other charges
1935	$8,532,277.12	$2,168,017.77
1936	10,343,134.86	3,619,687.25
1937	10,796,261.76	4,547,717.15
1938	9,910,662.19	3,514,249.97
Eight months ended (Ex. 187, R. 3784)—		
August 31, 1938	6,437,963.07	2,255,799.38
August 31, 1939	7,228,281.71	3,484,783.80

of the investment and the exceptionally strong position of the companies convinced the Commission that, at the time of the rate order, the companies could readily finance the enterprise at 6.24 percent with interest covered 4.68 times (R. 3939).[36] In view of the expert testimony to that effect (R. 2275–2276), as well as of the controlling factors we have mentioned, the Commission's allowance of a 6½ percent rate of return cannot be held unreasonable, but must, on the contrary, be considered extremely generous.

V

THE COMMISSION'S FINDINGS THAT THE COMPANIES' EXISTING RATES ARE UNREASONABLE AND THAT THE LEVEL OF RATES FIXED BY THE COMMISSION ARE REASONABLE ARE SUPPORTED BY SUBSTANTIAL EVIDENCE

The companies contend that there was no substantial evidence to support the finding of the Commission that the existing rates were unreasonable

[36] The companies seek to create the impression that the figures used by the Commission (R. 3939) show that the companies could not finance themselves at less than 6.72 percent (Br. p. 215). This is erroneous. The testimony (R. 2275–2276), as well as the Commission's opinion, shows that the proper figure is 6.24 percent. This is calculated as

within the meaning of the statute. They further argue that the considerations which support this conclusion likewise require the conclusion that there is no evidence to support the Commission's finding that the level of rates which it fixed was reasonable (Br., p. 145 *et seq.*). The argument is, apparently, that under the provisions of the Natural Gas Act there must be a finding that the companies' rates are unreasonable, that reasonableness of rates must be determined by the value and benefit of the service rendered, and that, accordingly, the fact that existing rates yield millions of dollars in excess of a fair return on the value of the property is not sufficient evidence to support a finding of unreasonableness. The court below dismissed the contentions because "they ignore the well-established holdings, backed by reason and experience, to the effect that a fair rate of return, on a fairly established rate base, supplies the correct test of reasonableness" (R. 4035). This holding, we submit is plainly correct.

Section 6 of the Natural Gas Act provides:

> (a) The Commission may investigate and ascertain the actual legitimate cost of the property of every natural-gas company,

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follows: The cost to the companies of bonds would be 40× .0375 or 1.50, the cost of preferred stock would be 20×.061 or 1.22, and the cost of common stock would be 40×.08 or 3.2, plus 10 percent or 3.52. The total is 6.24.

the depreciation therein, and, when found necessary for rate-making purposes, other facts which bear on the determination of such cost or depreciation and the fair value of such property.

(b) Every natural-gas company upon request shall file with the Commission an inventory of all or any part of its property and a statement of the original cost thereof, and shall keep the Commission informed regarding the cost of all additions, betterments, extensions, and new construction.

This section is modeled directly on Section 208 of the Federal Power Act, which was enacted as part of the Public Utility Act of 1935. As originally introduced in the Senate, this latter provision declared (S. 2796, 74th Cong., 1st sess.):

SEC. 208 (a) The Commission may investigate and ascertain the actual legitimate cost of the property of every public utility, the depreciation therein, and every fact which in its judgment has any bearing on the determination of such cost or depreciation.

(b) Every public utility upon request shall file with the Commission an inventory of all or any part of its property and a statement of the original cost thereof, and shall keep the Commission informed regarding the cost of all additions, betterments, extensions, and new construction.

(c) In determining just and reasonable rates, the Commission shall fix such rate as will afford the public utility an opportunity

> to earn a fair return on a rate base not in excess of the actual legitimate cost of the property used and useful for the service in question less the accrued depreciation therein.

The avowed purpose of the bill as thus drafted was to place rate regulation on the prudent investment basis. The Senate Committee on Interstate Commerce which reported the bill declared (S. Rep. 621, 74th Cong., 1st sess., p. 52):

> Rate regulation must eventually be based on prudent investment. Recent decisions of the Supreme Court, and the respect which the Court has always paid to the constitutional interpretations of the coordinate branches of the Government, afford grounds for hope that this rule which the committee considers essential to effective rate regulation will be sustained if the Congress should now definitely adopt it as a legislative policy. This would present the case to the Court in an entirely new light.

Prior to the final enactment of the statute, however, this Court in *West* v. *Chesapeake & Potomac Tel. Company*, 295 U. S. 662, reaffirmed the doctrine of *Smyth* v. *Ames*. Accordingly, the bill was reported out in the House with an amendment containing the present Section 208, which is identical with Section 6 of the Natural Gas Act.

It is thus clear that the Commission is authorized to establish reasonable rates on a prudent investment basis and that only if it is "found necessary",

(apparently because the rule of *Smyth* v. *Ames*), is there any occasion to consider facts bearing on "fair value". Whether the Constitution requires the adoption of the fair value basis or permits the application of prudent investment principles, however, the reasonableness of the rate is measured by the investment or fair value and not the value of the service to the consumer. If fair value is the test, the utility is entitled to a "fair return upon the reasonable value of the property at the time it is being used for the public". *Los Angeles Gas Co.* v. *Railroad Commission*, 289 U. S. 287, 305; *Railroad Commission* v. *Pacific Gas Co.*, 302 U. S. 388, 394–395; *Denver Stock Yard Co.* v. *United States*, 304 U. S. 470, 475.[37] This Court, it is true, has on occasion suggested that a "reasonable" rate may be higher than a "barely non-confiscatory" rate. See *Banton* v. *Belt Line Ry.*, 268 U. S. 413, 422–423; *Columbus Gas Co.* v. *Public Utilities Commission*, 292 U. S. 398, 414. Section 5 (a) of the Act,

[37] The case of *Canada Southern R. Co.* v. *International Bridge Co.*, [1883] 8 L. R. App. Cas. 723, cited by the companies to support a contrary ruling (Br. p. 151), is not in point. That was a suit between private parties, and it was conceded that the actual rates charged were reasonable. In this view, the court held that it would be improper to look to the company's profits to find unreasonableness. The court observed, however, that the legislature could provide otherwise. The dicta in *Cotting* v. *Kansas City Stock Yards Co.*, 183 U. S. 79, 95–97, which lends some support to the companies' position, are not in accord with the subsequent decisions of this Court.

however, which declares that "the Commission may order a decrease where existing rates * * * are not the lowest reasonable rates," was obviously designed to remove this hazy distinction and to authorize the Commission, in its discretion, to put in effect the lowest rates consistent with constitutional requirements.

There is in fact no other basis available to the Commission. The "value" of an essential service to the consumer obviously cannot be determined. See Brandeis, J., dissenting, in *St. Louis & O'Fallon Ry. Co.* v. *United States,* 279 U. S. 461, at 536–537; cf. Whitten-Wilcox, *Valuation of Public Service Corporations* (2d ed. 1928) pp. 248–250. And no useful purpose could be served by comparison of the companies' rates with those of other gas companies, since the comparison is not significant unless the rates of the other companies are reasonable. Cf. *Los Angeles Gas Co.* v. *Railroad Commission,* 289 U. S. 287, 305.

There can be no doubt that, under either the investment or fair value test, the rates charged by the companies are "unreasonable" and the level of rates prescribed by the Commission are "reasonable" in the sense of the statute. As we have shown above, the potential earnings of the companies at the level of rates ordered by the Commission are more than sufficient to earn a return of and a return on the investment, together with all other costs of operation. On the investment prin-

ciple, therefore, the Commission was permitted to find that the level of rates which it prescribed was reasonable and that the existing rates, which were above that level, were unreasonable. And though it was "found necessary" by the Commission to consider the reproduction cost in order, no doubt, to remove any possible doubt as to the validity of the order, the companies cannot seriously suggest that the addition to rate base allowed them as a consequence was "unreasonable."

If "fair value" is the test of constitutional validity and if, therefore, it is "found necessary" to consider the facts bearing on such value in order for the Commission to discharge its statutory responsibility, the rates are nevertheless "reasonable" in the statutory sense. For then the constitutional and statutory standards are the same and, for the reasons advanced in Point IV, the Commission's conclusions were correct, both as to result and, if this be necessary, as to method of valuation.

VI

SMYTH *v.* AMES IS NOT BASED ON SOUND PRINCIPLES AND SHOULD BE OVERRULED

In the case of *Driscoll* v. *Edison Light & Power Company*, No. 509, October Term, 1938, the United States filed a brief as *amicus curiae* asking that *Smyth* v. *Ames* be overruled. We have reprinted excerpts from that brief as a supplement to this

brief, showing that the present fair value rule is unworkable and unsound, that it has led to a breakdown of the rate-regulation process, and that it is contrary to the overwhelming weight of professional opinion. Here, we shall show, in addition, that the rule is based on legal principles drawn from the law of eminent domain which have no place in rate making, that in rate regulation the sole appropriate test is one of the reasonableness of the regulation and that a method of rate making which gives a fair return on the capital prudently invested in the enterprise is reasonable.

A. *The fair value rule is based on eminent domain concepts*

The rule that a rate is confiscatory unless it enables the utility to earn a fair return on the present fair value of its property is based on the doctrine in the law of eminent domain that "just compensation" must be paid for property "taken" for public use. The Court pointed this out in *West* v. *Chesapeake & Potomac Tel. Co.*, 295 U. S. 662, 671, saying:

> * * * When the property itself is taken by the exertion of the power of eminent domain, just compensation is its value at the time of the taking. So, where by legislation prescribing rates or charges the use of the property is taken, just compensation * * * is a reasonable rate of return upon that value.

The historical development of the fair value rule shows that the law of eminent domain was in fact its source. At first in *Munn* v. *Illinois,* 94 U. S. 113, and companion cases, the Court held that "the people must resort to the polls, not to the courts" for protection against abuses in rate regulation (94 U. S., at 134). Later, however, the Court receded from this extreme view and held that the question of the reasonableness of rates was a judicial question (*Railroad Commission Cases,* 116 U. S. 307, 325, 331; *Chicago Ry.* v. *Minnesota,* 134 U. S. 418), pointing out that unreasonably low rates could not validly be prescribed because that would amount to a deprivation of property without due process of law or a taking of property without just compensation. *Railroad Commission Cases,* 116 U. S. 307, 325, 331; *Georgia Railroad & Banking Co.* v. *Smith,* 128 U. S. 174, 179; *Chicago Ry.* v. *Minnesota,* 134 U. S. 418, 458; *Budd* v. *New York,* 143 U. S. 517, 547. Then, in *Reagan* v. *Farmer's Loan & Trust Co.,* 154 U. S. 362, the "fair value" rule emerged; the Court invalidated a rate order under which the company could not pay even one-half of its bond interest and said, *obiter* (p. 410):

> * * * If the State were to seek to acquire the title to these roads, under its power of eminent domain, is there any doubt that constitutional provisions would require the payment to the corporation of just compensation, that compensation being the value of

> the property as it stood in the markets of the world, and not as prescribed by an act of the legislature? Is it any less a departure from the obligations of justice to seek to take not the title but the use for the public benefit at less than its market value?

The analogy of a "taking" was not expressly referred to again until *Smyth* v. *Ames*, but in *Covington & Lexington Turnpike Road Co.* v. *Sandford*, 164 U. S. 578, 596, the Court observed that rates fixed so low as to destroy the value of property for all purposes would be invalid as a deprivation of property without due process of law. Finally the lower court in *Smyth* v. *Ames* held that the principles of eminent domain must apply in rate regulation, saying (*Ames* v. *Union Pacific Ry.*, 64 Fed. 165, 177 (C. C. Neb.)):

> Now, if the public was seeking to take title to the railroad by condemnation, the present value of the property, and not the cost, is that which [it] would have to pay. In like manner, it may be argued that, when the legislature assumes the right to reduce, the rates so reduced cannot be judged unreasonable if, under them, there is earned by the railroad company a fair interest on the actual value of the property. * * *

Thus this test extracted from the law of eminent domain became the basis of the "fair value" rule of *Smyth* v. *Ames* for determining the constitutionality of rates. See Henderson, *Railway Valua-*

tion and the Courts, 33 Harv. L. Rev. 902, 906–912; Hale, *Conflicting Judicial Criteria of Utility Rates,* 38 Col. L. Rev. 959, 960–964. As we have shown, the rule is still placed on that basis (*West* v. *Chesapeake & Potomac Tel. Co., supra*) and is invoked notwithstanding that when *Smyth* v. *Ames* was decided original cost exceeded "present fair value" and the rule was adopted to show that rates could be based on a value less than original cost. Today it is invoked to prevent rate regulation on any basis other than "present fair value" however much that value may exceed the cost of the property.

B. *The eminent domain concept of present fair value has no place in rate regulation*

In practice the "present value" test to which the Court has thus far adhered makes it impossible to measure the reasonableness of rates by any coherent or feasible standard. Physical property has only a scrap value unless it is capable of earning a return sufficient to justify a larger investment. In other words, the value depends on the earnings. And, since the earnings will depend on the rates to be fixed, the dilemma arises that value depends upon the rates fixed and the rates upon the value. The present fair value rule creates but offers no way out of this dilemma. See Bonbright, *Valuation of Property,* Vol. II, pp. 1094–1098; Hale, *The "Fair Value" Merry-Go-Round,* 33 Ill. L. Rev. 517–520.

The practical impossibility of developing a workable rule under the present fair value concept arises fundamentally from the fact that in principle the doctrine that "just compensation" must be paid for property "taken" has no application in the field of rate regulation. See Hale, *Conflicting Judicial Criteria of Utility Rates,* 38 Col. L. Rev. 959, 963.[38] This should have been apparent when *Smyth* v. *Ames* was decided. Prior to that decision, it had already been established in a utility condemnation case that "the value of the property, generally speaking, is determined by its productiveness—the profits which its use brings to the owner" (*Monongahela Navigation Co.* v. *United States,* 148 U. S. 312, 328–329; see also *C. C. C. & St. L. Ry.* v. *Backus,* 154 U. S. 439), and that compensation must be paid not only for the physical property but also for the franchise. Earning power under the old rates thus became the test of value in condemnation cases. Hale, *The "Fair Value" Merry-Go-Round,* 33 Ill. L. Rev. 517, 519–520; Hale, *Conflicting Judicial Criteria of Utility Rates,* 38 Col. L. Rev. 959, 964.[39] In a rate case, however,

[38] It was precisely this principle of "just compensation" that led Mr. Justice Field in 1877 to dissent in *Munn* v. *Illinois,* 94 U. S. 113, and to deny any power in the states to regulate rates. 94 U. S. at 143.

[39] Of course, where the property of a nonutility without franchise is condemned, it is only the physical property and not the earning power or prospective profits that are taken and paid for. *Mitchell* v. *United States,* 267 U. S. 341; *Joslin Co.* v. *Providence,* 262 U. S. 668; *Bothwell* v. *United States,* 254 U. S. 231.

as we have shown, the earning power necessarily depends on the rates to be allowed, which is the very question at issue, and unless earning power under the old rates is adopted as the measure of value, which obviously would prevent any reduction, the whole process becomes involved in a vicious circle. Bonbright, *op. cit. supra,* pp. 1094–1098; Bauer & Gold, *op. cit. supra,* 49 *et seq.,* 141–147; Hale, *The "Fair Value" Merry-Go-Round,* 33 Ill. L. Rev. 517–520; Henderson, *Railway Valuation and the Courts,* 33 Harv. L. Rev. 1031. As Mr. Justice Brandeis pointed out in his concurring opinion in *Southwestern Bell Tel. Co.* v. *Public Service Comm.,* 262 U. S. 276, 292:

> The rule of *Smyth* v. *Ames* sets the laborious and baffling task of finding the present value of the utility. It is impossible to find an exchange value for a utility, since utilities, unlike merchandise or land, are not commonly bought and sold in the market. Nor can the present value of the utility be determined by capitalizing its net earnings, since the earnings are determined, in large measure, by the rate which the company will be permitted to charge; and, thus, the vicious circle would be encountered. * * *

See also *Los Angeles Gas Co.* v. *Railroad Commission,* 289 U. S. 287, 305; Mr. Justice Stone dissenting in *West* v. *Chesapeake & Potomac Tel. Co.,* 295 U. S. 662, 689.

Moreover, the strict application of the eminent domain principle of "just compensation" to rate cases would render all rate regulation invalid. Present value would have to be measured by earnings at the old rates, and would be calculated by capitalizing those earnings at the prevailing rate of returns for investments involving similar risks. On the rate base thus determined, a fair return would have to be allowed which would, of course, be the rate of return on investments involving similar risks. The result would be no change in rates at all. The obvious truth of the matter is that every rate reduction which reduces the net earnings of a utility *ipso facto* reduces the value of that utility; if the value prior to the rate reduction must be preserved for constitutional reasons, it necessarily follows that every rate order which reduces that value is invalid.[40]

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[40] It is no answer to say that the dilemma is false because the actual market value will be less than the capitalized earnings by reason of the fact that the market will take into account the prospect of future rate regulation. A business has greater value if its owner can anticipate earnings in excess of just and reasonable profits, and the prospect of future regulation does not entirely diminish that anticipation. Hale, *The "Fair Value" Merry-Go-Round*, 33 Ill. L. Rev. 517, 530. If, therefore, under eminent domain principles, market value, which is earning power in the case of a public utility, sets the measure of "just compensation," and if rates must be fixed to pay the utility "just compensation" in the eminent domain sense, rates can never be reduced below the market expectations prior to the rate proceedings, and adequate rate regulation is still impossible.

This Court, while not professing to abandon the "taking" theory with its corollary requirement of "just compensation" (see *West* v. *Chesapeake & Potomac Tel. Co.*, 295 U. S. 662, 671), has adopted the logically inconsistent position that some rate regulation is permissible. In part the Court has permitted the exclusion of value supposedly due to "monopoly" position (*Clark's Ferry Co.* v. *Public Service Commission*, 291 U. S. 227, 238; see Whitten, *Fair Value for Rate Purposes*, 27 Harv. L. Rev. 419, 421–423; Richberg, *A Permanent Basis for Rate Regulation*, 31 Yale L. J. 263, 267), although an exclusive franchise is an element of value in a condemnation case. *Monongahela Navigation Co.* v. *United States*, 148 U. S. 312, 328–329. As Mr. Justice Brandeis remarked in *Southwestern Bell Tel. Co.* v. *Public Service Commission* (262 U. S. 276, 310–311):

> Value is a word of many meanings. That with which commissions and courts in these proceedings are concerned, in so-called confiscation cases, is a special value for rate-making purposes, not exchange value. This is illustrated by our decisions which deal with the elements to be included in fixing the rate base. In *Cedar Rapids Gas Light Co.* v. *Cedar Rapids*, 223 U. S. 655, 669; and *Des Moines Gas Co.* v. *Des Moines*, 238 U. S. 153, 165, good will and franchise value were excluded from the rate base in determining whether the prescribed charges of the pub-

> lic utility were confiscatory. In *Galveston Electric Co.* v. *Galveston,* 258 U. S. 388, the cost of developing the business as a financially successful concern was excluded from the rate base. In *Des Moines Gas Co.* v. *Des Moines,* 238 U. S. 153, 171, the fact that the street had been paved (and hence the reproduction cost of laying gas mains greatly increased) was not allowed as an element of value. But, obviously, good will and franchise value are important elements when exchange value is involved. And where the community acquires a public utility by purchase or condemnation, compensation must be made for its good will and earning power; at least under some circumstances. * * *

The very existence of the power to regulate rates, therefore, shows that the concepts of "just compensation" and "fair value," drawn from the law of eminent domain, have no place in rate cases. Bonbright, *op. cit. supra,* pp. 1092–1096; Bauer and Gold, *op. cit. supra,* p. 147; Beutel, *Valuation as a Requirement of Due Process,* 43 Harv. L. Rev. 1249, 1267; Hale, *The "Fair Value" Merry-Go-Round,* 33 Ill. L. Rev. 517, 519, 530; Hale, *Conflicting Judicial Criteria of Utility Rates,* 38 Col. L. Rev. 959. When property is taken under the power of eminent domain the owner "is entitled to the full money equivalent of the property taken and to be thereby put in as good position pecuniarily as it would have occupied if its property had not been

taken." *United States* v. *New River Collieries Co.*, 262 U. S. 341, 343. As we have shown, since value depends on earning power, the reduction of rates and consequent diminution of earnings necessarily diminishes the value of the utility property. Accordingly, it is to assert two mutually contradictory and inconsistent principles to say on the one hand that rate regulation is valid and on the other hand that rate regulation must secure to the property owner "just compensation" in the sense in which that term is used in the law of eminent domain.

C. *Rate regulation should be deemed violative of due process only if arbitrary or unreasonable*

The inconsistency is avoided once it is understood that rate regulation is not the taking of property for public use but is simply an exercise of regulatory power. Eminent domain is the power to command a sale; it involves a transfer of a title or a use which is essential to the Government's need, and not the curtailment of a private use or a restriction of private economic relations. Under the power of eminent domain, the public welfare is promoted by taking the property from the owner and appropriating it to some particular use. Lewis, *Eminent Domain* (3d ed. 1909), sec. 6. It is evident, therefore, that eminent domain concepts apply only where property is appropriated to the public use and where the taking is justified,

not because the property taken or the use of it is a public nuisance or other obstacle to valid legislative ends, but because it is needed for some valid public purpose or project. Nichols, *Eminent Domain* (2d ed. 1917) p. 278; Orgel, *Valuation under Eminent Domain* (1936) p. 2; see Gardner, *The Massachusetts Billboard Decision,* 49 Harv. L. Rev. 869, 889–892.

The regulation of rates, on the other hand, promotes the public welfare, not by a "taking", but by regulating and restricting the owner's use and enjoyment of his property. Lewis, *Eminent Domain* (3d ed. 1909), secs. 246, 249. And it is, of course, elementary that Congress may subject the use of privately owned property to reasonable limitations in order to serve valid legislative ends, even though the regulation diminishes the value of the property. As Mr. Justice Holmes remarked in *Block* v. *Hirsch,* 256 U. S. 135, 155:

> The fact that tangible property is also visible tends to give a rigidity to our conception of our rights in it that we do not attach to others less concretely clothed. But the notion that the former are exempt from the legislative modification required from time to time in civilized life is contradicted not only by the doctrine of eminent domain, under which what is taken is paid for, but by that of the police power in its proper sense, under which property rights may be cut down, and to that extent taken, without pay. * * *

Examples of valid legislative regulations which diminish the value of property without compensation are common. Thus, a state may declare that nets used on the waters of the state or on its shores in violation of fish protection statutes shall be summarily destroyed (*Lawton* v. *Steele*, 152 U. S. 133); that the manufacture of oleomargarine shall be prohibited (*Powell* v. *Penna.*, 127 U. S. 678); that the manufacture of intoxicating liquors shall be prohibited (*Mugler* v. *Kansas*, 123 U. S. 623, 661); that the business of conducting a livery stable shall not be carried on within certain territorial limits (*Reinman* v. *Little Rock*, 237 U. S. 171); that bricks shall not be manufactured within certain territorial limits (*Hadacheck* v. *Los Angeles*, 239 U. S. 394); that riparian owners shall not divert waters of a state into another state (*Hudson Water Co.* v. *McCarter*, 209 U. S. 349, 355); that the emission of smoke from buildings is unlawful even though the prevention of such emission would require the discontinuance of use of property and would involve much expense (*Northwestern Laundry* v. *Des Moines*, 239 U. S. 486); and that tanks containing inflammable fluid must be kept underground (*Standard Oil Co.* v. *Marysville*, 279 U. S. 582). Indeed, this Court upheld a statute which required the cutting down of red cedar trees of ornamental value to prevent infection of

apple orchards. *Miller* v. *Schoene,* 276 U. S. 272. In that case, this Court stated (pp. 279–280):

> * * * When forced to such a choice the state does not exceed its constitutional powers by deciding upon the destruction of one class of property in order to save another which, in the judgment of the legislature, is of greater value to the public. * * * And where the public interest is involved preferment of that interest over the property interest of the individual, to the extent even of its destruction, is one of the distinguishing characteristics of every exercise of police power which affects property. * * *

See also *Euclid* v. *Ambler Co.,* 272 U. S. 365; cf. *Pennsylvania Coal Co.* v. *Mahon,* 260 U. S. 393. Such reasonable restrictions on the use of property in the interest of the public have been held not to be "takings." *Monongahela Bridge Co.* v. *United States,* 216 U. S. 177, 193; *Union Bridge Co.* v. *United States,* 204 U. S. 364, 388–403; *West Chicago Street Railway* v. *Chicago,* 201 U. S. 506, 524; see Gardner, *The Massachusetts Billboard Decision,* 49 Harv. L. Rev. 869, 889–892.

Price regulation stands on the same footing as other exercises of the police power: the sole test is one of reasonableness. For example, in *Nebbia* v. *New York,* 291 U. S. 502, this Court, after observing that there was nothing "peculiarly sacrosanct about the price one may charge," concluded that "price control, like any other form of regulation,

is unconstitutional only if arbitrary, discriminatory, or demonstrably irrelevant to the policy the legislature is free to adopt, and hence an unnecessary and unwarranted interference with individual liberty." (291 U. S. at 532, 539.)

These principles apply to rate regulation, for such regulation is nothing more than one phase of the broader field of price fixing. No property is "taken"; the use of property is regulated. Indeed, the "taking" concept has not even a superficial relevance to utility regulation except where the state requires a utility to extend its service (*New York & Queens Gas Co.* v. *McCall*, 245 U. S. 345; *New York ex rel. Woodhaven Gas Light Co.* v. *Public Service Commission*, 269 U. S. 244) or forbids abandonment if the utility continues to do business anywhere within the state. *United Gas Co.* v. *Railroad Commission*, 278 U. S. 300, 308–309.[11] In some early cases, the power to fix prices or rates was explained by saying that the regulated com-

[11] No question of forbidding abandonment or compelling an extension is involved here. Moreover, the duty to continue or extend service is based upon the community's dependence for which the utility is responsible. Cf. Cardozo, J., dissenting in *Interstate Commerce Commission* v. *Oregon-Washington R. Co.*, 288 U. S. 14, 47. The instances are numerous and familiar in which a duty has been founded on dependence or reliance and in which the concepts of eminent domain are manifestly irrelevant. See, e. g., *Moch Co.* v. *Rensselaer Water Co.*, 247 N. Y. 160, 167; *Slater* v. *Illinois Central R. Co.*, 209 Fed. 480 (M. D. Tenn.); *Siegel* v. *Spear & Co.*, 234 N. Y. 479; *Creeley* v. *Creeley*, 258 Mass. 460, 463.

pany had "dedicated" its property to the public use. It is evident, however, from the fact that the property remains private property that there has been no true "dedication." *Minnesota Rate Cases*, 230 U. S. 352, 431–432; *Interstate Commerce Commission* v. *Oregon-Washington R. Co.*, 288 U. S. 14, 40–41.

As this Court observed in *Nebbia* v. *New York*, 291 U. S. 502, 534, "The statement that one has dedicated his property to a public use is * * * merely another way of saying that if one embarks in a business which public interest demands shall be regulated, he must know regulation will ensue."

Utility regulation, then, and rate fixing in particular, is not a "taking" of property for public use but an exercise of the police power. The validity of such regulation, therefore, does not depend upon impairment of the value of property; impairment of value is frequently the consequence of regulation. The true test of constitutionality under the due process clause in a rate case, as in all regulatory cases, is simply whether the regulation is reasonable.

D. *It is not unreasonable to limit the earnings of a utility to a fair return upon the capital prudently invested*

In urging that rate regulation which takes investment as the rate base is reasonable and therefore consistent with due process, we do not urge

that a legislature may not lawfully select other standards suggested by sound business practice. We do contend, however, that prudent investment is a reasonable measure.

The point requires little elaboration here. Mr. Justice Brandeis, in his concurring opinion in *Southwestern Bell Tel. Co.* v. *Public Service Commission,* 262 U. S. 276, has demonstrated the reasonableness of the investment basis by reference to a wealth of relevant data. Additional data are supplied in the supplement to this brief, where we show that the investment basis of rate regulation is sound and workable; that it is overwhelmingly supported by the great body of professional opinion, and that, despite the adherence by this Court to the doctrine of *Smyth* v. *Ames,* many regulatory bodies have advocated utilization of the investment test. It is significant, too, that practical experience in Massachusetts, California and elsewhere shows that this method is just to the utilities, has attracted capital, and has secured adequate service. Since this basis of rate regulation maintains the company's financial integrity and permits it to raise necessary capital, it cannot be deemed arbitrary. Hale, *Conflicting Judicial Criteria of Utility Rates,* 38 Col. L. Rev. 959, 969–970.[42]

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[42] "* * * The money necessary for the proper discharge of its public duties, or necessary to finance the whole enterprise, is not the replacement cost. * * * To raise that necessary money, it will be requisite that the company have a prospect, in the assumed case, of earning 9% on the full

The contrast of the record of that experience with the confusion resulting from application of the fair value rule emphasizes the reasonableness of the investment test. On the basis of long experience, almost all informed opinion is agreed that effective rate regulation under the present value test is a practical impossibility. In the supplement to this brief we show that the rule is unrelated to the end sought, i. e., the allowance of a compensatory return on property devoted by investors to the public service, that it produces arbitrary, unreliable, and absurd results, and that it results in a breakdown of the regulatory process.

The argument commonly advanced for the present value rule is that the basis of rate regulation is the necessity of providing an effective substitute for conditions of competition and that, since under conditions of competition, present or reproduction cost and not original investment controls the prices charged the consumer, the same principle must be applied in rate regulation. See Whitten, *Fair Value for Rate Purposes*, 27 Harv. L. Rev. 419, 421; Richberg, *A Permanent Basis for Rate*

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actual prudent cost defrayed by the investors, no matter how much less it would have cost at the time of the regulation. It will be unnecessary for the purpose that the company have a prospect of earning 9% on anything more than actual prudent cost, no matter how much more it would have cost had the plant been built at the time of the regulation. Money sufficient for building the plant at higher replacement costs is not necessary for the proper discharge of the company's public duties." Hale, *op. cit. supra*, at 970.

Regulation, 31 Yale L. J. 263, 277. The argument, it may be noted, in effect concedes that the full measure of just compensation required in the case of a taking under eminent domain is not required in rate regulation, since the standard of competition permits the reduction of earning power, that is, the value of the property, below the level existing under monopoly conditions. It seems equally clear that, as a matter of due process, there is ample reason to believe that the competition theory is not only unworkable in practice but is not properly related to the legitimate aims of utility regulation. The cost of reproduction which is a measure of prices in private industry is the cost, not of reproducing the identical property, but of reproducing the service. Whitten, *op. cit., supra,* at 426–427; Richberg, *op. cit., supra,* at 277. Such a basis for rate making is entirely unfeasible, because it would require the rate-making agency to decide, upon conflicting evidence, the engineering question of how a plant should be constructed in order most efficiently to render the service now rendered by the utility, and then to determine the cost of building this hypothetical plant (*id.*). Moreover, conditions of competition offer a very imperfect standard for rate regulation. The competitive price may yield large profits to the low cost producer but it brings ruin to the high cost producer. The public, however, has a definite interest in preventing financial

distress which will prevent efficient public service. Bonbright, *Merits of Original Cost and Reproduction Cost*, 41 Harv. L. Rev. 593, 621–622.

It is true that to measure the rate base by the sum prudently invested does not allow the owners of utility property the same appreciation in values which owners of other property enjoy in times of prosperity. By the same token, however, the use of the investment method saves utility investors from the depreciation in values from which investors in other types of business suffer in times of depression. The adoption of this test, therefore, cannot be said to be unreasonable on this ground. Under the rule of *Smyth* v. *Ames*, on the other hand, utility investors get both the benefit of appreciation in property values and protection against depreciation. This is so because, in periods of deflation, regulatory agencies cannot undertake to fix values in strict conformity to *Smyth* v. *Ames* without throwing many utilities into receivership, and this would, of course, deprive consumers of necessary utility service.[43]

[43] "Why, say the defenders of reproduction cost, should railway security holders be given any greater insurance against the fluctuations of price levels than is given to the holders of securities in an unregulated enterprise? The answer is that when the investors in small competitive enterprises fall, they may fall alone, but when the holders of railway securities fall, they force the whole community to become unwilling mourners of their downfall." Bonbright, *Merits of Original Cost and Reproduction Cost*, 41 Harv. L. Rev. 593, 621–622; see Whitten, *Fair Value For Rate Purposes*, 27 Harv. L. Rev. 419, 423–424.

Experience of the past decade has shown that in fact electric, gas, and lighting utilities have not shared with the rest of the community in loss of earnings (Ex. 185, schedule 17, R. 3697–3699). As Mr. Justice Brandeis so aptly observed, "The rule by which the utilities are seeking to measure the return is, in essence, reproduction cost of the utility or prudent investment, whichever is the higher." *Southwestern Bell Tel. Co.* v. *Public Service Commission*, 262 U. S. 276, 311. Since the utilities are not compelled to suffer from a decline in values, it is not unreasonable to deny them the increase."

As the Government stated in its brief in *Driscoll* v. *Edison Light & Power Co.*, 307 U. S. 104 (see supplement to this brief, p. 41), the rule of prudent investment, combining as it does exactness, ease of application, and a proper principle for the determination of reasonable return, is the standard for rate making best adapted to modern business conditions and practices in this country. The case at bar offers the Court an opportunity to write off the books the unsound and unworkable rule of rate making enunciated in *Smyth* v. *Ames*. We urge, therefore, that *Smyth* v. *Ames* be overruled and that this Court now announce that prudent invest-

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"Even if it be assumed that some account must be taken for the factor of increasing prices, this may readily be accomplished by altering the rate of return. See Whitten, *Fair Value for Rate Purposes*, 27 Harv. L. Rev. 419, 434–435; Richberg, *A Permanent Basis for Rate Regulation*, 31 Yale L. J. 263, 273.

ment is a reasonable and therefore valid basis for the regulation of rates.

CONCLUSION

The decision of the court below should be reversed and the case remanded with directions to enforce the Commission's order in full.

Respectfully submitted.

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APPENDIX A

The Natural Gas Act of 1938, c. 556, 52 Stat. 821, 15 U. S. C., Supp. V, §§ 717–717w, provides:

SEC. 1. (a) As disclosed in reports of the Federal Trade Commission made pursuant to S. Res. 83 (Seventieth Congress, first session) and other reports made pursuant to the authority of Congress, it is hereby declared that the business of transporting and selling natural gas for ultimate distribution to the public is affected with a public interest, and that Federal regulation in matters relating to the transportation of natural gas and the sale thereof in interstate and foreign commerce is necessary in the public interest.

* * * * *

SEC. 4. (a) All rates and charges made, demanded, or received by any natural-gas company for or in connection with the transportation or sale of natural gas subject to the jurisdiction of the Commission, and all rules and regulations affecting or pertaining to such rates or charges, shall be just and reasonable, and any such rate or charge that is not just and reasonable is hereby declared to be unlawful.

* * * * *

SEC. 5. (a) Whenever the Commission, after a hearing had upon its own motion or upon complaint of any State, municipality, State commission, or gas distributing company, shall find that any rate, charge, or classification demanded, observed, charged, or collected by any natural-gas company in

connection with any transportation or sale of natural gas, subject to the jurisdiction of the Commission, or that any rule, regulation, practice, or contract affecting such rate, charge, or classification is unjust, unreasonable, unduly discriminatory, or preferential, the Commission shall determine the just and reasonable rate, charge, classification, rule, regulation, practice, or contract to be thereafter observed and in force, and shall fix the same by order: *Provided, however,* That the Commission shall have no power to order any increase in any rate contained in the currently effective schedule of such natural gas company on file with the Commission, unless such increase is in accordance with a new schedule filed by such natural gas company; but the Commission may order a decrease where existing rates are unjust, unduly discriminatory, preferential, otherwise unlawful, or are not the lowest reasonable rates.

* * * * *

SEC. 6. (a) The Commission may investigate and ascertain the actual legitimate cost of the property of every natural-gas company, the depreciation therein, and, when found necessary for rate-making purposes, other facts which bear on the determination of such cost or depreciation and the fair value of such property.

(b) Every natural-gas company upon request shall file with the Commission an inventory of all or any part of its property and a statement of the original cost thereof, and shall keep the Commission informed regarding the cost of all additions, betterments, extensions, and new construction.

* * * * *

SEC. 9. (a) The Commission may, after hearing, require natural-gas companies to carry proper and adequate depreciation and amortization accounts in accordance with such rules, regulations, and forms of account as the Commission may prescribe. The Commission may from time to time ascertain and determine, and by order fix, the proper and adequate rates of depreciation and amortization of the several classes of property of each natural-gas company used or useful in the production, transportation, or sale of natural gas. Each natural-gas company shall conform its depreciation and amortization accounts to the rates so ascertained, determined, and fixed. * * *

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SEC. 13. Any State, municipality, or State commission complaining of anything done or omitted to be done by any natural-gas company in contravention of the provisions of this Act may apply to the Commission by petition, which shall briefly state the facts, whereupon a statement of the complaint thus made shall be forwarded by the Commission to such natural-gas company, which shall be called upon to satisfy the complaint or to answer the same in writing within a reasonable time to be specified by the Commission.

* * * * * *

SEC. 19. (a) Any person, State, municipality, or State commission aggrieved by an order issued by the Commission in a proceeding under this Act to which such person, State, municipality, or State commission is a party may apply for a rehearing within thirty days after the issuance of such order. The application for rehearing

shall set forth specifically the ground or grounds upon which such application is based. Upon such application the Commission shall have power to grant or deny rehearing or to abrogate or modify its order without further hearing. Unless the Commission acts upon the application for rehearing within thirty days after it is filed, such application may be deemed to have been denied. No proceeding to review any order of the Commission shall be brought by any person unless such person shall have made application to the Commission for a rehearing thereon.

(b) Any party to a proceeding under this Act aggrieved by an order issued by the Commission in such proceeding may obtain a review of such order in the circuit court of appeals of the United States for any circuit wherein the natural-gas company to which the order relates is located or has its principal place of business, or in the United States Court of Appeals for the District of Columbia, by filing in such court, within sixty days after the order of the Commission upon the application for rehearing, a written petition praying that the order of the Commission be modified or set aside in whole or in part. * * * No objection to the order of the Commission shall be considered by the court unless such objection shall have been urged before the Commission in the application for rehearing unless there is reasonable ground for failure so to do. The finding of the Commission as to the facts, if supported by substantial evidence, shall be conclusive. If any party shall apply to the court for leave to adduce additional evidence, and shall show to the satisfaction of the court that such additional evidence is

material and that there were reasonable grounds for failure to adduce such evidence in the proceedings before the Commission, the court may order such additional evidence to be t ken before the Commission and to be adduced upon the hearing in such manner and upon such terms and conditions as to the court may seem proper. The Commission may modify its findings as to the facts by reason of the additional evidence so taken, and it shall file with the court such modified or new findings, which is supported by substantial evidence, shall be conclusive, and its recommendation, if any, for the modification or setting aside of the original order. The judgment and decree of the court, affirming, modifying, or setting aside, in whole or in part, any such order of the Commission, shall be final, subject to review by the Supreme Court of the United States upon certiorari or certification as provided in sections 239 and 240 of the Judicial Code, as amended (U. S. C., title 28, secs. 346 and 347).

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APPENDIX B

The operation of the sinking fund formula

Year (1)	Amount to be Amortized (2)	Annual Amortization Allowance (3)	6½% Interest on Reserve (4)	Reserve for Amortization (5)
1 (1932)	$78,284,000	[1] $1,562,610		$1,562,610
2 (1933)	78,284,000	1,562,610	$101,570	3,226,790
3 (1934)	78,284,000	1,562,610	209,741	4,999,141
4 (1935)	78,284,000	1,562,610	324,944	6,886,695
5 (1936)	78,284,000	1,562,610	447,635	8,896,940
6 (1937)	78,284,000	1,562,610	578,301	11,037,851
7 (1938)	78,284,000	1,562,610	717,460	13,317,921
8 (1939)	78,284,000	1,562,610	865,664	15,746,195
9 (1940)	78,284,000	1,562,610	1,023,503	18,332,308
10 (1941)	78,284,000	1,562,610	1,191,600	21,086,518
11 (1942)	78,284,000	1,562,610	1,370,624	24,019,752
12 (1943)	78,284,000	1,562,610	1,561,284	27,143,646
13 (1944)	78,284,000	1,562,610	1,764,337	30,470,593
14 (1945)	78,284,000	1,562,610	1,980,588	34,013,791
15 (1946)	78,284,000	1,562,610	2,210,896	37,787,297
16 (1947)	78,284,000	1,562,610	2,456,174	41,806,081
17 (1948)	78,284,000	1,562,610	2,717,395	46,086,086
18 (1949)	78,284,000	1,562,610	2,995,595	50,644,291
19 (1950)	78,284,000	1,562,610	3,291,879	55,498,780
20 (1951)	78,284,000	1,562,610	3,607,421	60,668,811
21 (1952)	78,284,000	1,562,610	3,943,473	66,174,894
22 (1953)	78,284,000	1,562,610	4,301,368	72,038,872
23 (1954)	78,284,000	1,562,610	4,682,527	78,284,000
Total		35,940,030	42,343,979	

[1] The Commission's annual allowance for amortization, $1,557,852, is slightly less than that required to yield $78,284,000 in 23 years at 6½% interest compounded annual. This slight error, however, is plainly *de minimus* and is not complained of by the companies here.

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